BANKING

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BANKING

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PREFACE

JUST one hundred years have elapsed since the legalisation in England of joint-stock banking apart from the Bank of England. The century has seen the complete differentiation of Central Banking and Deposit Banking —the transfer from banks of deposit of the power of the "creation of credit" as expressed in the expansion or contraction of the currency, and its concentration in the hands of the State, delegated wholly or partially to State Central Banks; while to banks of deposit is left only the function of distributing the credit which for them is created by their depositors. It has been my object to make clearer this last evolution in the banking system. The development of Central Banking has been going on in all the countries which share in the large trade in the world, and I have briefly touched upon the principles which have recently been adopted in some of them. For Deposit Banking I have dealt mainly with the British system, for it is in Great Britain that the elaborate machinery of the financing of industry and commerce has been

most completely developed. There seems to be prevalent a popular misconception of the part which deposit banks play in the system, and it has been my aim to oppose any undue exaggeration of their powers and influence.

It only remains to me to express my gratitude to those who have assisted me in the preparation of this little book by their advice, their criticism, and the collection and certification of the facts and figures needed. I most warmly thank my friends Mr. John Rae, Chief General Manager of the Westminster Bank, and Mr. S. H. Marchant, of the same Bank; without their help I could not have completed my task.

WALTER LEAF.

21st *July*, 1926.

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CHAPTER I

WHAT IS A BANK?

In dealing with such a subject as Banking it would seem desirable that we should begin with a definition, and explain exactly what is meant by the words "Bank" and "Banking." Strange to say, it seems quite impossible to lay down any general definition. The theory and practice of banking have varied from age to age, and still vary from country to country. In most countries banking is carried on under duly codified legislation, and there is little doubt as to the legal definition of a bank. In the United States, for instance, a bank is a corporation holding a bank charter either from the Federal Government, as a "National" Bank, or from a State Government. The functions of an American bank, and the conditions under which they can be exercised,

are laid down by law, and inspectors are appointed by the Governments, whether National or State, who grant the charter, to see that these conditions are strictly observed. The line between banks and other corporations is sharply drawn.

In England, however, no such legal definition exists. Gilbart, in his book on Banking, quotes from a speech in the House of Commons in 1745 the following words: "What is it that we call a Banker? There is in this City a company or corporation called goldsmiths, and most of those called bankers are of that corporation; but so far as I know, there is not a company or corporation called bankers, nor has the business any definition or description either by common law or by statute. By custom we call a man a banker who has an open shop, with proper counters, servants, and books, for receiving other people's money, in order to keep it safe, and return it upon demand; and when any man has opened such a shop, we call him a banker, without inquiring whether any man has given him money to keep."

That statement is, I think, still essentially true. There have been certain negative enactments, as we shall see directly—things

which banks must not do. There are certain protections given to bankers in the course of their business. Curiously enough, though it might seem that the main business of the banks is money-lending, a "money-lender" under the Money-lenders Act must not call himself a banker. On the other hand, it appears that it is open to anybody to take out at Somerset House a certain document known as a "Banker's Licence"; it is only necessary to pay a fee, and no questions are asked as to the character of the business to be carried on under the licence. But there is no legal definition of a bank, unless it be that which appeared in the Finance Act of 1915, to the effect that a bank was a person or corporation "carrying on a *bona-fide* banking business," which recalls the historical definition of an archdeacon.

There is, however, a fairly clear general notion, in England at least at the present time, of what is meant by a bank, and though the margin is not very sharply defined, a bank's area of action is recognised within limits of variation narrow enough to preclude any serious difficulties in practice. In fact there does not seem to be any case in the Courts where a decision has turned upon an

accurate definition, and though it is possible to imagine such a case, it is one which is not very likely to arise. But it is certain that if a definition of a bank were required to-day, it would be a different definition from any that would be accepted in another country, or that would have been accepted in England even a hundred years ago. To understand this it will be well to look back, not upon the general history of banking, which is excluded by considerations of space, but upon the outlines of the development of English banking during the last century. And it must be understood that "English" banking does not include Scottish banking, which has grown on quite different lines, though the systems of the two countries now approach something like agreement in practice.

At the beginning of the nineteenth century English banking was carried on under three sharply defined systems. In the centre was the Bank of England, a joint-stock bank, working for the profit of its shareholders, but having the sole privilege of carrying on the Government account, and possessing in fact, though not by law, sole right of issue of notes in London. It was protected in its position by a law providing that no corporation con-

sisting of more than six partners might issue promissory notes payable at demand (*i.e.* bank notes) anywhere in England. This was understood to mean that no joint-stock banking was permitted.

Beyond the London area the country was covered by numerous small private banks which made a profit, and assisted industry, by the issue of their own notes. These had grown up chiefly from the credit of the rich men of the neighbourhood, very often the local brewer or cloth-weaver, whose name stood high on the country market. It was easy and highly profitable for him to make loans to his neighbours, issuing notes which he undertook to pay when presented, so long as he could reckon on a fair delay in presentation. If the notes were accepted as currency and passed from hand to hand in the market, then, so long as they were out, the issuer was receiving interest, probably at what would now be considered a very high rate, on his original loan, and paying none himself. He was employing no capital of his own, and receiving a handsome income merely on the credit of his name.

But by the side of these two banking systems, that of the Bank of England in

London and the private banks of issue outside the London area, there had been growing up another class of banks, the private banks within London itself, who were doing an important business by re-lending, mainly on commercial securities, moneys deposited with them by their customers. These banks had grown out of the London goldsmiths' shops. In the uneasy days of the seventeenth century, these had been bound to make a special study of the safe custody of their own valuable assets, and were ready to offer their services to those of their customers who had either cash or other valuables which they wished kept in greater safety than their own houses could offer. Hence had arisen a custom of depositing with the goldsmiths any cash which was not needed for the moment, to be repaid at some date in the future. It was evident that cash thus deposited could be re-lent at interest, so long as it could be called in by the time when repayment was required; and it was worth the goldsmiths' while to offer a moderate interest on money deposited with them for a fixed time, re-lending it at a higher rate for a corresponding period. As experience grew, it was found that it would be safe to reckon on a certain proportion of

the total deposits being left in practical permanence, at all events while business was running smoothly; it could thus be lent out at interest without regard to any conditions as to the fixing of the period for which deposits were made; in other words, money could be taken on deposit repayable on demand, and yet a certain proportion could be lent for short periods with safety. Thus there came into being the "current account" withdrawable on demand, and following upon this the introduction of the cheque as a transferable instrument. This great discovery, the foundation of modern banking, is not traceable to the genius who invented it. The earliest instance of the use of the word in the New English Dictionary in this sense is dated 1774; but the use of written orders to pay, under the title of "drawn notes," is certainly much earlier.

Whatever the date of the introduction of the cheque, the important point for us is that by the opening of the nineteenth century there had grown up in London round the Bank of England a powerful body of private banks, the descendants of the goldsmiths, who were attracting deposits from their customers, and using them for the financing of trade in the

City by discounting trade bills, making advances upon goods in the course of sale, lending upon easily realisable securities such as those dealt in on the Stock Exchange and venturing a certain proportion on such less liquid security as deeds of premises. They had, in fact, developed the system of deposit banking as we know it. The history of English banking for the next hundred years is summed up in the extension of this system to joint-stock banks, and the absorption by them of the private banks—a process which is now complete, for all practical purposes, so far as the country is concerned, and almost complete in London.

The monopoly of joint-stock banking claimed, and long enforced, by the Bank of England was based upon the following provision in the Charter of 1708: "During the continuance of the said corporation of the Governor and Company of the Bank of England, it shall not be lawful for any body politic or corporate whatsoever, created or to be created (other than the said Governor and Company of the Bank of England), or for any other persons whatsoever, united or to be united in covenants or partnership, *exceeding the number of six persons*, in that part of Great Britain called England, to borrow, owe, or

take up any sum or sums of money on their bills or notes, payable at demand, or at a less time than six months from the borrowing thereof."

In 1708, and for long afterwards, it was supposed that no bank could carry on business successfully unless it had the right to issue notes; and this clause in the Charter was always understood to confer on the Bank a monopoly of joint-stock banking in England. But by the early years of the nineteenth century it was proved, by the practical experience of the private banks of London, that deposit banking, without any right of note issue, was feasible and profitable. The London banks worked in alliance, instead of competition, with the Bank of England, and did not issue notes, though such of them as had not more than six partners possessed the legal right to do so. Still it was not, apparently, till 1822 that attention was directed to the fact that the clause in the Charter left it open to a joint-stock company to carry on a banking business so long as they did not issue notes. The Bank of England protested, but public opinion was aroused by the disastrous panic and the collapse of small country banks in 1825; and in 1826 a bill was passed which expressly

allowed banks having more than six partners to carry on business in England at a greater distance from London than sixty-five miles, provided they had no establishment as bankers in London. They must not issue notes at a place within sixty-five miles of London, nor draw any bills on London for a less amount than £50. In other words, joint-stock banks might be established in the country, with powers of issue; but, whatever might be the true reading of the Bank Charter, no legislative sanction was given to the establishment of any joint-stock banks in London itself or its neighbourhood. That did not come till 1833, when the renewal of the Bank's Charter was accompanied with a clause which recited that whereas it was intended that the Bank of England should continue to hold all the exclusive privileges of banking conferred by previous Acts, and whereas doubts had arisen as to the construction of such Acts, and it was expedient that such doubts should be removed, it was enacted that "any body politic or corporate, or society or company or partnership, although consisting of more than six persons, may carry on the trade or business of banking in London, or within sixty-five miles thereof, provided that (they) do not

borrow owe or take up in England, any sum or sums of money on their Bills or notes payable on demand or at any less time than six months from the borrowing thereof."

The Act of 1833 was followed early in 1834 by the establishment first of the London and Westminster Bank, and then by that of the London and County Banking Company. The former was established with the intention that it should confine itself to London, while the latter took as its area the sixty-five-mile radius, covering the home counties. The country joint-stock banks, however, had a start of some years, and it may be mentioned that of the existing "Big Five" only one, the Westminster Bank, had its origin in London, and all the others came to London from the provinces—the Midland Bank and Lloyds Bank from Birmingham, the National Provincial, whose first branch was at Gloucester, and Barclays Bank by an amalgamation of numerous private banks in the eastern counties, owned mostly by Quaker families generally connected by marriage. It may be noticed too that the present year 1926 marks the centenary of the legal establishment of joint-stock banking in England outside the pale of the privilege of the Bank of England.

The Bank of England received the intruders with a very bad grace, and every legal obstacle was put in their way. The private bankers of London joined in the ban, and for a long time refused the joint-stock banks admission to the Clearing House. It was largely due to the determination and genius of Mr. J. W. Gilbart, the manager of the London and Westminster Bank, that the victory was ultimately won. Mr. Gilbart celebrated a striking triumph when the London and Westminster Bank bought up the business of Jones, Loyd & Co., the bank of their chief opponent in the past, the famous private banker Lord Overstone.

The distinction between London and country banking naturally arose from the fact that the earliest country banks possessed the right of note issue, uncontrolled by any legal restrictions; it was not until Peel's Bank Act of 1844 that this right was restricted, and provision made for its gradual extinction. The country banks which came to London had to surrender it; but the fact that many of them found it worth their while to do so is evidence of the supplanting of issue banking by deposit banking, which has been completed only within the last ten years by the final

extinction in England of the note issues of English banks other than the Bank of England, which, under this Act of 1844, remains the only bank in England issuing its notes payable to bearer on demand.

It is now possible to give a definition of English banking, and to define a bank in terms of its deposit business. We can say that a bank is a person or corporation which holds itself out to receive from the public deposits payable on demand by cheque. This does not express more than one part of the business of a bank; but it does express the characteristic by which a bank is, to the common apprehension of the public, distinguished from other financial institutions. But it must be repeated that the definition only holds good for Great Britain, including Ireland as well as Scotland, and perhaps for the United States. But it would not be applicable on the Continent, where the use of the cheque is too little developed to be regarded in any sense as a fundamental part of the operation of a bank; and a definition would rather be sought from the discounting of bills and the giving of monetary credits.

CHAPTER II

CENTRAL BANKING

Before we can discuss the functions of a Bank of Issue, and more particularly of a Central Bank, it is necessary to look briefly at the nature of the currency of a country; for it is with the creation and regulation of this that Banks of Issue and Central Banks are in the first place concerned.

In the general economic system which has grown up in modern Europe and America one of the most important factors is the use of currency as a machinery for the exchange of goods and services, in place of the primitive system of barter. For this purpose it is usual to employ the precious metals; within the last century gold has taken an almost exclusive place, silver, which at one time was a serious competitor, being now relegated, where it is used at all, to the inferior position of a material for token coins.

But gold, though it has many advantages,

has drawbacks as currency. It is expensive, and as a great deal has to be kept in hand as a reserve beyond what is actually working at any time in effecting sales and purchases, it involves loss of interest as well as cost of storage. It is, moreover, limited in amount, and is not easily transferred from place to place.

Now the need for currency in actual use varies from time to time; more is needed when transactions are frequent and when prices are high. Both prices and activity of transactions vary largely from time to time; there is notably a large seasonal variation. The time of harvest is a period when much currency is required. The staple food for a whole year has to be gathered and marketed in the space of a few months of autumn and early winter. Hence the autumn has always been, by the laws of nature, a time when more currency is needed to finance sales and purchases than at other times of the year.

It was found out long ago that this period of stringency could be easily passed through, if people in general were prepared to take, in place of coin, promises to pay coin made by men reputed to be wealthy and honourable, and who might therefore be relied upon to

fulfil their promises to pay when called upon to do so. In other words, credit could be created and used to supply the place of currency. The farmer who had to pay his workmen for their labour and keep during the harvest would go to the man of means in his neighbourhood—we may at once call him the banker—and borrow from him promises to pay coin on demand, which would be accepted by his men because they could use them with the shopkeepers. They in their turn would pass them on in exchange for goods, and so they would go from hand to hand. In course of time the farmer would have sent his wheat to market, where it would be sold and perhaps after some months he would receive payment for it in " notes " of the banker from whom he had borrowed or some other banker. These he would pay back to his lending banker; the credit given him would be duly cancelled, and the notes, if issued by the lender himself, retired, or, if issued by another banker passed on to be cancelled by him in exchange for cash.

But this system of a credit currency, though admirably simple and economical in its working in normal times, had a great drawback. In all progressive and commercially enterprising communities there come from time to

time periods of speculation, when everyone is convinced that he can easily make a fortune in a little time, if he can only get command of a little capital to start with. At such times it is fatally easy, and most tempting, for the banker to supply the capital by the creation of more credit; for no one troubles much about the interest he has to pay when sudden wealth is in view. Thus bank notes are multiplied beyond all the bounds of legitimate trade. Everyone seems well off, prices rise, and goods are imported on the inflated credit. But creditors abroad will not accept in payment the promises of local bankers here; they want coin, and the foreign exchanges go against us; there is a heavy draft on the nation's stock of gold. Then comes the reaction; some shock to credit, some failure in the schemes of over-sanguine and often fraudulent speculators, breaks down the general spirit of confidence. The reaction reaches a point where people begin to wonder whether the bankers are in a position to meet their promises to pay their notes in gold. After all, in the long run, everyone wants the real coin, not the piece of paper; and if the amount of gold in the country is diminishing, one begins to wonder if one will get one's

share unless one makes haste. There begins a "run" on the banks. The banker has reckoned, from his experience of normal years, that a certain large percentage of his notes will always be outstanding, and keeps coin in hand only sufficient to cover a "reasonable" proportion of his liabilities. But he suddenly finds that no one is "reasonable"; panic is universal, and his reserves are being rapidly exhausted. He sends off post-haste to his correspondent in the capital, and requests an immediate loan in coin, for which he can deposit undoubted security. The correspondent replies that he does not doubt the security, but that he can with difficulty get enough coin to supply his own needs, and can certainly not find any for the country, as the stock of gold in the Bank is getting dangerously low. The result is that the country banker, though he may be in the long run perfectly solvent, has to announce that he is unable to meet his notes in coin—he "suspends payment." The further result is that his customers who hold his notes are reduced to desperation, and immediate, and perhaps final, poverty. This is the tragedy which has been played over and over again, not only in England, but in every country which has

reached a certain point of economic development. The circle of events seems so certain, and its culmination so disastrous, that every country has been forced to take steps to control it. The problem everywhere has been the same—to obtain the benefits of a "fiduciary" currency, that is, a currency based upon the credit of the issuer, while avoiding its great danger. The benefits of a paper currency are first a great economy, namely, the use of a very cheap machine of paper in place of a very expensive one of gold; and secondly, an immense elasticity; a fiduciary currency can be expanded at will to meet the needs of commerce and industry. The great danger of it is the ease with which it can be used for artificial inflation, that is, an increase of credit beyond what is needed for the normal conduct of business. The increase shows itself in a general rise of prices, for more money is used to effect the same amount of sales. But as gold is still the nominal measure of prices, this means that gold has fallen in value compared to other commodities; and therefore foreign countries prefer to take gold, the price of which has not risen, rather than other goods in payment of debts due to them. Thus the over-cheapness, or depreciation of paper

currency, shows itself in the form of a drain of gold to foreign countries. So long as gold is freely purchasable by currency, and its export is freely permitted, a cheapness of gold as expressed in the price quoted for it by other countries, *i.e.* in the course of the foreign exchanges, is an infallible index of inflation.

When Governments, therefore, set themselves seriously to retain the advantages of a paper currency while controlling the evils of undue inflation arising from an excessive issue of paper money, or undue extension of credit in other directions, they have turned to the institution of some central body which could be entrusted with the task of watching the general stock of gold, and empowered to take steps to repress any undue expansion of credit, while holding power to increase the supply of currency when the legitimate demands of trade require it. As a corollary to the establishment of such an institution, the issue of currency by other bodies has been either wholly abolished or severely restricted. Such are the main functions of a "Central Bank" as now conceived. A Central Bank may also exercise other functions, such as keeping the Government accounts, issuing public loans, and the like; but these are not

essential to its character as a Central Bank, and are shared with it to some extent by other banks.

With these considerations in view we will now proceed to examine some of the most important Central Banking systems; and we will begin with the oldest and largest of all, the Bank of England.

The Bank of England is indeed the pivot of the English banking system. But there are contained in it two banks. By Sir Robert Peel's Bank Act of 1844, which still regulates the constitution of the Bank of England, there are created two Departments of the Bank, the Issue Department and the Banking Department. These are kept rigidly distinct, and make separate returns of their position every week.

Up till 1844 the Bank of England, as we have seen, had by practice, though not by law, a monopoly of the issue of notes in London and its neighbourhood. These notes were not, however, legal tender till 1833; though up to that time they enjoyed the privilege of being accepted in payment of taxes and other Government dues, and thus had a prestige which greatly favoured their circulation. When in 1833 they were made

legal tender, their convertibility was to all intents and purposes guaranteed by the nation, and it was logically only a question of time when the issue of them was formally controlled by law. By the Bank Charter Act of 1844 the whole question of the issue of bank notes was so settled as to bring it gradually under complete legal control. Till then, as we have seen, any private bank with not more than six partners could issue, in England, an unlimited amount of its own notes. In periods of "boom," of rising prices and speculation, the temptation of easy profits thus offered was irresistible; and the over-issue of notes by unregulated inflation was followed as a matter of course by times of panic when the issuing banks had their notes returned to them for redemption in cash in masses with which they could not deal, and wholesale suspensions followed. In the political difficulties of 1797, when national inflation began owing to the war then being waged with France, there was a run on the Bank of England, and specie payments had to be suspended by Parliament, not to be resumed till 1821, six years after the ending of the war—about as long, it may be noticed, as the interval between the end of the Great

War and the return to the gold standard in 1925. But before the resumption of cash payments there had been successive crises in country banking in 1814 to 1816; during those three years 240 country banks stopped payment, and 89 went into bankruptcy. There was another outburst of speculation in 1824–5, followed by the inevitable collapse; in six weeks in 1825 above seventy banks went down. This crisis was the cause of the first legislation directed to control the currency. The Act of 1826 in the first place removed the restriction on the number of partners in banks, and permitted the establishment of joint-stock banks outside London; and in the second, forbade the issue of bank notes of a less denomination than £5. This, of course, was done in the hope that the risks of the poorer members of the community might be minimised. But the restriction was futile. The new joint-stock banks which were established in the country under the Act took advantage of the power given them to issue £5 notes, and hastened to bring them into circulation; a new period of inflation was thus brought about, followed by a collapse in 1836 and 1837, when a panic was barely averted. The Bank of England failed to protect its reserves, and in September 1839

had to seek help from the Bank of France. It became evident that the whole banking system of the country had broken down, and a radical reform was needed.

The plan adopted was as follows. In the first place, the control of the issue of bank notes was taken out of the direction of the Bank of England, and rendered automatic. The fiduciary issue, that made on the credit of the Bank, and supported by the standing debt of the Government to the Bank, was fixed at £14,000,000. Any issue of notes in excess of this amount could only be made against a deposit of an equal amount of gold. At the same time the issue of notes by country banks was restricted to those banks who already had the right of issue; and the amount issued was in no case to exceed the average amount of notes in circulation during twelve weeks preceding 27th April, 1844. Moreover, not only could no bank not previously possessing the right issue notes in future, but if any issuing bank joined a joint-stock bank, or by amalgamation increased the number of its partners beyond six, the issue was lost altogether. But, on the other hand, in such a case the Bank of England was allowed to increase its fiduciary issue by two-thirds of

the amount of the cancelled country issue. Thus in the course of time the total amount of the fiduciary issues of the country was to be actually diminished by one-third of the amount of the country issues, and the whole was to be concentrated into the hands of the Bank of England. It may be mentioned here that this process has in practice been very slow, much slower than the supporters of the measure expected; and it was only in 1920 that the last country note issue was cancelled. The fiduciary issue of the Bank of England has now been raised by about two-thirds of the issues cancelled to its present figure of £19,750,000.

The Bank was thus made responsible for the management of the currency of the country indirectly. It could not increase its circulation except by increasing its stock of gold. And it could influence its stock of gold only through its Banking Department. By raising its rate of discount it could attract gold from abroad by the prospect of investment at a better rate of interest; and at the same time it could discourage speculation based on an expected rise in prices by making it less worth while to borrow for such speculation, and by encouraging holders of speculative stocks of

all sorts to sell rather than hold for the rise. On the other hand, when prices were falling and business was dull, it could make it easier for producers to borrow money by reducing the rate at which it was prepared to lend. The main sign for its action was the state of the foreign exchanges. If the stock of gold here was unduly large, the rates of exchange were in favour of England; and as soon as they reached the point at which it would pay to import more gold, the bank rate would be lowered, and the import of gold discouraged. On the other hand, when gold reserves were low, the exchange would be against this country and the signal was given for a rise in the bank rate.

On the whole the new system may be said to have worked fairly well till the outbreak of the Great War. But it had one great fault; it was too inelastic to meet extreme cases of panic. It was, in fact, too slow in action. It used to be an old saying in the City that "7 per cent. will bring gold from the moon"; but it takes time to bring it even from Paris. There have been moments when sudden runs upon the stock of gold have taken place to an extent which have exceeded the Bank's power of maintaining it. At such times the Bank

has had to issue notes beyond the legal amount. This has been done on the written authority of the Prime Minister and the Chancellor of the Exchequer, who undertake to apply to Parliament for legal sanction if necessary. It is a fundamental axiom that in times of panic the one remedy is to lend freely, and to let it be known that loans on approved security will be granted with exceptional liberality. The action of the Government in "suspending the Bank Act" has always produced a speedy restoration of confidence; the mere announcement that cash is available has always stopped a run.

During the last century the power to exceed the legal limit of the fiduciary issue was given on three occasions, 1847, 1857 and 1866. The last occasion when the power was sought was on the outbreak of war in August 1914. It will be instructive if we turn to this and trace the public record of the events of that eventful time. For this purpose it will be well to set out the weekly return which, under the Act of 1844, the Bank has to make, and to trace the significance of the various items there set out. The weekly return is still a most valuable guide to the money market; before the war it was yet more valuable. The

figures which follow are the last of the old régime; though they are still published weekly in the same form they now give a less complete picture of the financial position. We begin then with the weekly return which immediately preceded the crisis.

Bank of England

Accounts pursuant to the Act 7 and 8 Victoria, Cap. 32, for the week ended on Wednesday the 29th day of July, 1914.

Issue Department.

Notes issued	£55,121,405	Government Debt . .	£11,015,100
		Other Securities . .	7,434,900
		Gold Coin and Bullion .	36,671,405
		Silver Bullion . . .	—
	£55,121,405		£55,121,405

Banking Department.

Proprietors' Capital . .	£14,553,000	Government Securities .	£11,005,126
Rest	3,491,756	Other Securities . .	47,307,530
Public Deposits (including Exchequer, Savings Banks, Commissioners of National Debt, and Dividend Accounts)	12,713,217	Notes.	25,415,055
Other Deposits . . .	54,418,908	Gold and Silver Coin .	1,460,139
Seven-day and other Bills	10,969		
	£85,187,850		£85,187,850

The meaning of the return of the Issue Department is evident. The total amount of bank notes issued at that date was £55,121,405, against which was held in gold £36,671,405. Though it is legal for the Bank to hold a certain small proportion in silver, in practice this

is never done, and the line for silver bullion is always blank. The other two lines, "Government Debt" £11,015,100, and "Other Securities" £7,434,900, together make the "fiduciary issue," which the Bank can legally put out against advances made to the Government, and against securities transferred from the Banking Department. The amount of the fiduciary issue was thus at the date of the above return £18,450,000. It was raised on the 13th February, 1923, by £1,300,000 to the sum of £19,750,000, at which it now stands. In 1844 the fiduciary issue was fixed at £14,000,000, and the provincial issues were £8,631,647. These having gradually lapsed, the Bank has exercised its claim to add two-thirds of the amount to its fiduciary issue, and the final limit under the present Charter has been reached.

The items in the Banking return need more explanation. The Proprietors' Capital has been fixed from time to time at renewals of the Charter, and now stands at £14,553,000. The "Rest" is undivided profit. This is never allowed to fall below £3,000,000, and in each half-year the surplus beyond that amount furnishes sufficient for the half-year's dividend. Naturally the profits added to the Rest are

those which the Bank sees fit to declare, after making provision for inner reserves.

"Public Deposits" represent, as set out, the balances standing to the credit of various Government departments. So far as the City is concerned, they are an element of mystery; why they increase or diminish from time to time and how far they may be set off by the Government Securities on the other side of the account is a matter of guess-work. It is, however, possible to note the increase in the balances in February and March, when the great ingathering of taxation takes place, and the temporary drops when heavy interest payments on Government stocks are made. The item in the Government accounts which most affects the money market, namely, the Government overdraft known as "Ways and Means Advances," is the subject of a special statement.

The most important item on this side of the account is that of "Other Deposits," which includes the deposits on current account of (*a*) the customers of the Bank in its ordinary banking business, and (*b*) the balances kept by other banks. What the proportion of these two may be is not known; before the war it was, according to the usual guess, about half

and half. But it is certain, from the experience of other banks, that the ordinary customers' deposits vary only slowly, and any marked variation in this item from week to week must be due to changes in the bankers' balances. In the return before us there had been a great and sudden increase from £42,185,297, the week before, on July 22, to over £54,000,000 on July 29. This means that in the anticipation of imminent trouble the banks were strengthening their balances at the Bank of England in preparation for the calls which were certain to come should war break out.

The last item, "Seven-day and other Bills," refers to the "Bank post Bills," which are issued by the Bank of England itself for seven days' usance only, the practice of issuing sixty days' bills having been discontinued twenty years ago. The Bank issues them to its own customers free of stamp duty and commission. They appear to be used principally for convenience when travelling abroad, as they can be readily cashed. The amount varies, but the total is always negligible.

Passing to the other side of the account, the first item, "Government Securities," is, like "Public Deposits," too much involved in the

mysteries of inter-departmental book-keeping to give much information to the outside world. The second line, however, is of great interest to the market. The "Other Securities" represent the amount of borrowing from the Bank both by its regular customers and by the money market. It includes both loans against securities and bills discounted. We have seen how in this particular week the banks had increased their balances with the Bank of England by some £12,000,000. This line shows how it was done. The banks had not indeed borrowed direct from the Bank of England, nor discounted bills with the Bank; they make it a rule not to do that. But they had been calling in their short loans from the money market. As we shall see when we come to deal with the money market, this "put the market in the Bank"; the discount houses and others with whom the short loans are placed could only repay the banks by borrowing at the Bank of England, which they had done either by discounting bills or borrowing upon bills and gilt-edged securities. Thus the total of "Other Securities" rose from £33,632,762, on July 22, to £47,307,530 on the 29th. This increase of nearly £14,000,000 roughly corresponds to the increase in "Other

Deposits," showing where the money had gone.

The two next lines "Notes" and "Gold and Silver Coin" constitute what is called the "Reserve," the amount of cash which the Bank keeps in hand for the purpose of the till, that is, in order to meet the calls which may be made upon it for payments, whether by way of loan or for withdrawals. The percentage which the Reserve bears to the liabilities to the public (*i.e.* other than to its shareholders for Capital and Rest) is known as the "proportion," and is an index to the strength of the Bank's position. In this case the two lines together amount to £26,875,194, and the "proportion" to the "Public" and "Other" deposits, £67,132,125, is almost exactly 40%. This was not, in the days before the war, a particularly low figure for the "proportion"; it was generally held that the minimum which was safe was 30%, and when that was approached a rise in the bank rate was confidently looked for. But the proportion of 40% on July 29 was a marked falling-off from the preceding week, when it had been over 52%, and the drop was significant. Since the war, indeed, it has been the custom to work with a much smaller proportion,

and the ratio may fall to 15% without exciting any alarm. It is generally round about 20%. In 1914, however, things were different, and the position as shown by the next return, which we will now consider, plainly shows the severity of the crisis which the country had been through. It will be remembered that in August 1914 the regular Bank Holiday fell on Monday the 3rd. But by Saturday the 1st it was clear that war was coming. The first week in August is always a time for large withdrawals of cash for holiday purposes. But this year there was something of a panic, and on the Friday and Saturday the banks were besieged by customers calling for gold. The pressure grew so great that on the Saturday the bank rate was raised to 10%, the Governor of the Bank obtained from the Prime Minister and the Chancellor of the Exchequer the letter authorising a suspension of the Bank Charter Act, and an order was issued extending the Monday Bank Holiday to Tuesday, Wednesday and Thursday. So it was that the next Bank return was made for the evening not of Wednesday the 5th, but of Friday the 7th. A return on Wednesday would have been equivalent to Saturday the 1st, the last banking day, and would have

shown if the Bank Act had actually been violated—that is, whether in the return of the Issue Department, while the "Government Debt" remained unchanged, the "Other Securities" had exceeded the legal limit of £7,434,900. But if that did happen it had been put right by the Friday. Even so the Friday's return is eloquent enough.

BANK OF ENGLAND

An account . . . for the week ended on Friday the 7th day of August, 1914.

Issue Department.

Notes Issued . . .	£44,491,070	Government Debt . .	£11,015,100
		Other Securities . .	7,434,900
		Gold Coin and Bullion .	26,041,070
		Silver Bullion .	——
	£44,491,070		£44,491,070

Banking Department.

Proprietors' Capital . .	£14,553,000	Government Securities .	£11,041,152
Rest	3,547,083	Other Securities . .	65,351,656
Public Deposits . . .	11,499,452	Notes.	8,385,650
Other Deposits . . .	56,749,610	Gold and Silver Coin .	1,580,999
Seven-day and other Bills	10,312		
	£86,359,457		£86,359,457

In this return we notice at once the great change in the Issue Department; Notes Issued have fallen by over ten and a half millions. The amount of the fiduciary issue is not exceeded, so there has been just the same drop in the item of Gold Coin and Bullion. On

Friday and Saturday the banks had been busy in supplying their customers' demands for gold, often handing them bank notes, which were taken to the Issue Department to be changed for gold. Thus £10,630,335 had been presented in notes and withdrawn in gold, the notes being thereby cancelled. And the return of the Banking Department shows where the notes had come from. The Gold and Silver Coin in the Reserve has hardly been touched; but the Notes have shrunk by no less than seventeen millions, to £8,385,650. The Bank has been busy in paying them out by way of loans and discounts, and the Other Securities have been swollen by eighteen millions, from £47,307,530 to £65,351,656. And the "proportion" has fallen from 40% to 14·6%. The ten millions in reserve would have been exhausted by two more such days as the Friday and Saturday, and the Bank could not have met the calls upon it.

But in the same week a change had been made which deprived the Bank Return of its significance. The Currency and Bank Notes Act had been passed on August 6th, and the provision of cash had been taken over by the Treasury, acting through the Bank, and there was no further need to be anxious about

obtaining currency. In fact from this time, owing to the method of accountancy adopted by the Bank and the Government, the Bank Return became more and more unintelligible, and bankers ceased to pay any attention to it during the war. I may perhaps be allowed a personal anecdote: I was discussing the Bank Return with the Governor of the Bank during the war, and mentioned that there was only one line of it which I thought I understood; and that was the line "Gold Coin and Bullion." The Governor, with a twinkle in his eye, replied, "Mr. Leaf, I do not think you understand even that."

The control of the currency has gone through three complete revolutions since the outbreak of the war, and another is impending. It will be well at this point to recapitulate the different systems.

(1) From 1844 to 1914 the Bank Charter Act, moderated by three "suspensions," was the controlling authority. Under this Act the issue of notes for currency purposes was strictly limited to the fiduciary powers of the Bank of England, the gradually diminishing fiduciary powers of the country banks, and to the gold which had to be deposited, earmarked £ for £ against any further issue. During the period

1894–1913 the Bank held gold varying normally from about £33,000,000 to £38,000,000. The amount held was returned week by week, and carefully watched in the market. It was generally understood that in normal times if the former figure was approached the bank rate was likely to be raised; if the latter, a reduction might be expected. In addition to the Bank of England's stock of gold, large amounts were held in reserve also by the banks, and a still larger amount was in circulation in the country. What these sums came to, either separately or in the aggregate, was not known; though various estimates were made from time to time, no authoritative confirmation was possible.

(2) On the outbreak of the war a new fiduciary currency was established by the issue of notes through a department of the Treasury. The amount and manner of the issue was left to the absolute discretion of the Treasury. This was essentially a War Loan free of interest, for an unlimited period, and as such was a highly profitable expedient from the point of view of the Government. The effects of it were, however, modified by the fact that practically the whole of the gold in circulation was called in, not by any legal enactment,

but by moral suasion, and most of it was passed on to the Bank of England. In so far as the issue of Treasury notes was merely a substitution of £1 and 10*s.* notes for sovereigns and half-sovereigns it was not a measure of inflation at all, but merely a change in the form of the currency such as obtains in many countries as the normal form of currency—in the United States, for instance, no coin larger than a dollar circulates in a metallic form, and even the metallic dollar is rarely seen except in the West. Throughout the war both bank notes and Treasury notes were theoretically convertible into gold. But the export of gold was, though not forbidden, closely controlled under the Defence of the Realm Act, and not permitted to any private person. A certain amount of gold was allowed to manufacturers—dentists needed it, for instance, and there was a large demand for wedding rings. The only other purpose for which it could be worth the while of anyone to change notes into gold was for the illegal object of melting down the coin of the realm; and on this ground the demanding of gold in exchange for notes was a highly suspicious operation and subjected anyone who attempted it to a surveillance which amounted in practice to a

prohibition. The banks continued to hold reserves of gold of their own, but the greater part of what they received from the public was paid in from time to time to the Bank of England. Although an export of gold continued under Government supervision, no returns were made public, and it was supposed, though never publicly stated, that a very considerable part of the stock of gold which appeared in the Bank returns was in fact not in the vaults of the Bank at all, but was held for them in Ottawa, Cape Town, Melbourne, and even in New York.

Through the whole of this period (1st January, 1916–21st March, 1919) the American exchange was "pegged," that is, it was kept steady at $4·76½ to the £, rather below the parity of exchange, but sufficiently high to prevent any profit on the export of gold, a process which during war-time was abnormally costly. This pegging was made possible only by large loans in the United States and very large sales of American securities held by British nationals (some £950 millions), which for the time took the place of exports of gold. But this resource had its limits; it was impossible to continue borrowing indefinitely, and the load of debt was already heavy

enough. It was accordingly decided, in 1919, that the American exchange must be left to find its own level, and that the fact of a serious depreciation in sterling must be faced.

(3) Thus came about another change in fiscal policy. Hitherto the gold standard had been maintained in theory, but had already gone by the board as an effective policy. It was certain that, as soon as the American exchange was unpegged, there would be a serious fall, which would bring about at once disastrous exports of gold, unless restrictive measures were adopted. The first step was to forbid by legislation the export of gold, except under special licence. This regularised the practical prohibition which had grown up during the war; it was the actual abandonment of the gold standard. For no person could bring notes to the Bank and turn them into gold with which to pay a debt owing by him outside the kingdom. And even within the kingdom the restriction on the use of gold was made closer, inasmuch as by agreement, though not by legislation, the joint-stock banks handed over to the keeping of the Bank of England for the Treasury all the gold which they had in their vaults. The

Bank therefore obtained for the first time a complete control of the whole gold reserves of the country.

It was under this system that the country passed through the great crisis, the tremendous fall in prices of 1921–2. This fall was not due to any policy of deflation; it was a world-wide phenomenon, which, in fact, began not here but in Japan. It was due to a sudden realisation of the fact that the world, in the frenzied outburst of speculative production which followed the end of the war, had increased its output of goods of every sort far beyond the power of the impoverished nations of Europe to purchase. The fall in prices brought with it a great deflation of the currency; as prices fell, the amount of currency needed to buy and sell the goods became less, and the issue of Treasury notes fell off. At the same time the nation was rapidly paying off debt, and thus cancelling the excess of credit which had been created during the war. The deflation of prices and reduction of currency went hand in hand. The general index-number for wholesale prices for Great Britain according to the *Economist* fell between January 1921 and December 1922 from 255·3 to 193·8, and in the same period the total

amount of Treasury notes current fell from £367,626,000 to £301,336,000.

At the same time the American exchange, as had been foreseen, began to go against us; and the number of dollars which were equivalent of £1 fell from the "pegged" figure of 4·76½ to a minimum of 3·21¾. As the process of deflation came to an end in England, the dollar exchange began slowly to rise. The regularity of the rise was interrupted by a false alarm of fresh inflation towards the end of 1923; but throughout the early part of 1924 a steady improvement set in, and by July 1924 a return to the gold standard began to be a matter of practical politics.

(4) The decisive step was taken on April 28, 1925, when the Chancellor of the Exchequer, as a preface to his Budget speech, announced that the embargo on the export of gold, which had been legally enacted for the period up to December 31st, would not be renewed on that date, and that in the meantime licences for the export of gold would be freely given. This placed the country on the gold standard, so far as international trade was concerned. But it was decided that, for the protection of the gold reserves held by the Bank of England, it was necessary that the circulation of gold

coin should not be resumed. The obligation of the Bank to pay both Treasury Notes and its own bank notes in gold coin, £ for £, had been nominally maintained, as provided by the law, since the outbreak of the war. This obligation was now abolished; the Bank was given the option to pay notes in gold coin if it wished to do so, but was no longer compelled. On the other hand, it undertook to sell gold in bars of not less than 400 oz. fine at the Mint price of £3 17*s.* 10½*d.* per oz. standard, so that anyone wishing to export gold could obtain bullion but not specie. The right of the holder of bullion to have it coined at the Mint was withdrawn. It may be mentioned that this plan, proposed by the eminent economist Ricardo, was adopted in 1819, when the Government, after the long suspension of payments during the Napoleonic wars, was proposing to return to gold.

It has been pointed out that, under the Currency and Bank Notes Act of 1914, there was no limit whatever to the discretion of the Treasury; notes might be issued to any amount that the Chancellor of the Exchequer of the day thought fit, and no provision whatever was made for any gold backing. But a certain amount of gold, and subsequently some

silver, was set aside as a partial cover. The percentage of gold to the total issue was entirely arbitrary, but as gold coin returned from circulation when displaced by notes, the total amount placed to reserve against the Treasury notes rose to £27,000,000. This was subsequently transferred to the Bank of England, and bank notes were taken against it. The state of the Treasury Notes issue for the week ended 26th May, 1926, was as follows:

Treasury Notes Outstanding:		Government Securities	£249,604,425
		Bank of England Notes	56,250,000
£1 Notes	£237,239,340	Silver Coin	6,550,000
10*s*. Notes . . .	42,964,446	Balance at Bank of England	125,594
Certificates . . .	18,760,000	Investments Reserve a/o	£12,261,852
Total . . .	£298,963,786		

(which includes £1,304,381 notes called in but not yet cancelled).

Fiduciary Issue, £242,713,786—this being the total of the Treasury Notes outstanding—£298,963,786—less the total of Bank of England Notes held, namely, £56,250,000.

The Treasury, however, by a Minute issued on the 15th December, 1919, declared its policy to be a gradual reduction in the total issue of Treasury notes, and to this end announced that the total amount of notes uncovered by gold or Bank of England notes at any time in any year would be limited to the maximum amount attained in the previous year. Thus the total fiduciary amount might be reduced, but could never be in-

creased. The limit was thus reduced year by year as follows:

	£
1920 :	320,600,000
1921 :	317,555,200
1922 :	309,988,400
1923 :	270,183,800
1924 :	248,190,900
1925 :	248,145,400
1926 :	247,902,500

It will be seen that the limit has now reached a point below which it is not likely to fall, so long as conditions remain much as they are at present; so long, that is, as the general level of prices does not greatly vary from the present point, and there is no great boom in trade such as will call for a large addition to the volume of currency. In fact the limit is already too low to allow for the temporary expansion of currency which normally takes place in the holiday seasons at Christmas and the beginning of August, when there is a general demand for cash. Thus at Christmas 1924, and again at the beginning of August 1925, the demand for Treasury notes increased till the fiduciary issue, the amount not covered by gold or Bank of England notes,

exceeded, or threatened to exceed, the maximum of the year preceding. The Bank of England was therefore called upon to deposit notes to cover the deficiency. This was, of course, equivalent to an export of gold from the Bank.

Under the present system, therefore, the absolute control of the currency is vested in the Treasury, that is, in the hands of the Chancellor of the Exchequer for the time being. It is within his power to inflate the currency to any extent that he may think fit; he may make Government loans to an unlimited amount by directing the Treasury to issue currency notes and place them at the disposal of any person or body whom he may wish to favour. He is entirely free from any control, whether of the House of Commons or of his own colleagues in the Government, so long as he can keep his transactions out of the annual Budget. He can, of course, after the deed is done, be expelled from office; but what he thinks fit to do is within the limits of the law in any case, and cannot be rescinded by his punishment.

So far the Treasury, as we have seen, has voluntarily limited its issues by Minute; but the Minute is no more than a declaration of

policy, and may be cancelled without notice. It has only been maintained in existence as long as it has by the help provided by the Bank of England. If at any time there should be a financial panic necessitating an expansion of the issue, it would no longer be necessary for the Bank to apply for a suspension of the Act; all that would be needed would be an order for the issue of so many Treasury notes on the fiduciary basis.

Hitherto this abandonment by Parliament of all control, logically only justifiable as an emergency measure to meet the stress of war, this legal establishment of an absolute financial dictatorship, has been satisfactory in its application. The Governor of the Bank of England has been taken into a sort of informal partnership with the Chancellor, and all their steps have been guided by an enlightened regard for the national credit. But conditions may change, and it can hardly be held that the present position is anything but temporary. The only other Government, so far as I am aware, which has been placed in a similar position is that of the Czecho-Slovakian State. Here the stabilisation of the currency, involving a large measure of deflation, was placed in the hands of the Ministry of Finance, aided by a

consultative Committee. But when stabilisation was attained, the issue of currency was handed over to a State bank legally established and provided with means to maintain the value of its notes.

It can hardly be long before some fresh arrangement is made by which the sole power of note issue will be given back to the Bank of England. The whole system of currency regulation will then have to be reopened. The choice will be between a return to the strictly limited and mechanical system of the Bank Charter Act, with largely extended powers of fiduciary issue, as it is impossible now to abolish at once the whole excess issue of Treasury notes; or, on the other hand, some sort of arrangement as that which, in one form or another, exists in most foreign countries—an arrangement under which the Central Bank is allowed to issue a certain proportion of currency against the discount of approved commercial paper and/or Government securities, in place of the deposit of actual gold which our present system demands. This plan has the great advantage of elasticity. In a time of pressure and panic it gives all banks the power of helping their customers by lending freely either upon securities or by

the discount of their bills, with the knowledge that they can always depend upon obtaining the necessary funds from the Central Bank by re-pledging the securities or re-discounting the bills.

It is, in fact, the means adopted by the United States in the reform of their issue system which took place just before the war; and it is necessary that for the sake of comparison a short account should be given of this. This is the more important because recent events have drawn the two systems into close contact, and the course of business in England has largely depended upon co-operation between London and New York. The Federal Reserve Board's policy, as reflected in the Reserve Banks' discount rates, particularly in New York, has had a great influence on the bank rate in London.

American banking had a bad start; it was from the first a victim of the politicians. When the Republic was first founded a bitter contest arose between the school of Alexander Hamilton, who wished to see a strong central authority, and that of Jefferson, who was a supporter of State rights as against those of the central Federal Government. It was natural that Hamilton should favour a central

bank and that Jefferson should oppose it. It is needless to dwell on the chequered and unhappy career of the Bank of the United States, first formed under Hamilton's auspices, and finally, after it had been a leading political issue in the Presidential election of 1832, virtually destroyed by executive action, though its charter had not yet expired, in 1833. From that time American banking became purely provincial. Banks established under State law held the field; no general legislation existed, and under this system the issue of notes was practically unlimited. The amount of notes issued, which in 1830 was estimated at something over $66,000,000, had in 1837 risen to $149,000,000. In the latter year the crash, the natural offspring of rapid inflation, came, and it is believed that every bank in the United States, without exception, suspended payment. This brought about action in most of the States to restrain the evils of uncontrolled issue. In the State of New York, for instance, "incorporated" banks under State law were required to contribute one half per cent. of their capital annually to a security fund, devoted to payment of the notes of defaulting banks. This, however, was practially a dead letter, as it

acted directly to encourage rash banking; the speculative banker knew that his risks were to a certain extent at least covered by the funds of more cautious establishments, and lost any sense of responsibility. In addition to the "incorporated" banks there was a system of "free" banks; all individuals or associations who chose to deposit securities with a minimum of $100,000 were allowed to issue an equal amount of notes. This permission was largely used; but it had the obvious objection that it made no provision for the immediate payment of notes; in time of panic the securities became unsaleable, and notes were repaid only after a long period of liquidation, and rarely if ever in full, as the securities in such periods could only be sold at less than the price at which they had been pledged.

This did not stop panics; another occurred in 1857, and once more, it is said, every bank in the United States stopped payment. But before any further reform in the banking system had been effected the Civil War came in 1861, and altered the whole position. The Federal Government took upon itself the issue of notes which were inconvertible and legal tender. The Government thus obtained a

forced loan not bearing interest, coin was driven out of circulation, and gold went to a large premium. By the Banking Law of 1863 the whole banking system of the country was altered. A Currency Bureau with a Controller of Currency was set up in Washington, with power to authorise banking associations of not less than five persons to be established, with a minimum capital of $100,000. Any such bank must transfer to the Treasurer of the United States any United States interest-bearing bonds, not less than one-third of the capital stock, and should thereupon receive from the Controller of Currency circulating notes of different denominations equal in amount to 90% of the current market value of the bonds, but not exceeding their par value. Under this law large numbers of existing banks were transformed into "national" banks, and their existing notes were withdrawn in exchange for the new national bank issue, which soon obtained currency throughout the United States, regardless of the bank issuing, as they were all backed by adequate security in the United States Treasury.

The new system, though in the long run it secured the safety of the notes, did not

prevent banking crises. It had the grave defect of erring on the side of rigidity as much as the old erred on the side of laxity. America is a land which has always been eminently dependent upon harvests. The great grain and cotton crops which form the staple of its exports are all harvested in the autumn, and sent at once to the various ports, mostly on the east coast, for export. The sums required for the gathering and moving of the crops are very large, and the call for currency in the last four months largely exceeds the needs of the rest of the year. There was no organised provision for meeting this call and spreading it over twelve months.

In 1912 there were some 30,000 banks scattered through the United States. All were individual units, with no coherence or "team-work." They had substantial reserves supposed to be available in an emergency; but these largely consisted of sums placed on deposit with other banks, which in their turn deposited their reserves with yet other banks; and by this system of "pyramiding" no bank could call up its so-called "first-line" reserves without causing a disturbance through a long line of banks, probably ending

in New York. There was no central institution like the Bank of England or the Bank of France which could keep a watch over a general reserve fund, and transmit it almost automatically to the point where it was needed. The currency system was notably inelastic. The securities which were almost exclusively used as a basis for note issue were United States 2% bonds of 1930. These were always in demand for this purpose, and consequently always more or less at a premium. The banks got but little return upon them as an investment, and they looked rather to the price at which they could be bought than to the necessities of the country for currency. "In other words, the expansion and contraction of the bank-note circulation was not, as it should have been, in response to variations in trade demands, but in response to variations in the price of the Government debt" (Kemmerer). Moreover, the purchase and deposit of the bonds involved a great deal of red-tape and delay before the supply of fresh notes could be obtained from Washington. Then, again, rigid requirements for the reserve to be held against all loans made it difficult for the banks to increase their book credits when trade was expanding. Nor could banks

lend their credit by accepting bills, as is done in Europe on a large scale; for the courts had decided that acceptance of bills by banks was illegal. The evil results of the American system are thus summed up by Dr. Kemmerer.

"To this defect of credit inelasticity coupled with that of decentralisation were to be attributed largely the frequent and wide fluctuations in the interest rates on call and short-time loans, for which American money markets were notorious, the alternation of periods of excessive speculation stimulated by redundancy of currency and credit with periods of stringency and liquidation brought on by scarcity. For this rigidity of our credit system the business men and the farmers paid the price of higher interest rates; the farmer suffered through the necessity of selling his staple crops largely in the fall when a tight money market was depressing prices, and of buying his supplies largely in the early spring when easy money conditions tended to make prices abnormally high; the banker was compelled to keep large reserves and to tie up an excessive amount of his commercial deposits in capital investments, such as the purchase of bonds and the making of call loans on stock exchange collateral;

while upon all classes in the community an uncertain and unstable money market, which was wont to collapse frequently in panics, imposed the burden of great financial anxiety." The system with these defects naturally operated to the great disadvantage of the foreign trade of the United States. This was mostly financed through London by the system of bank acceptances. For instance, an exporter of coffee from South America to New York would be reimbursed by a sterling draft on London which the New York importer had to arrange with a London bank, who took the commission payable on the transaction.

In short the inefficiency of the American banking system had long been a by-word when the great panic of 1907 convinced even the most conservative American banker that something must be done. The reform of the system was hotly debated for several years, and it was not till 1914 that the "Federal Reserve Act" was passed by Congress just in time, as it happened, to assist in the enormous expansion of business involved in the outbreak of the war, and afterwards to finance the huge loans issued by the United States on their entry into the war in 1917.

The new system was in the nature of a compromise. The long tradition of American public opinion, grown almost into a test of patriotism, rejected any real centralisation of banking; it was not possible to set up a real "Bank of the United States" with the authority of the Bank of England or the Bank of France. American banking has always been and remains essentially provincial; the sense of "State Rights" is outraged by the thought of a Federal Bank interfering all over the country, just as by a rigid veto on branch banking, even within the limits of the State (the chief exception being California), an effective limit is set to the growth of individual banks, and the small local banker retains a favoured position from which he is not likely to be ousted. It need hardly be added that this is the exact contrary of the tendency which is to be seen in English banking, which has for the last century been steadily progressing through amalgamation to complete concentration in London.

The United States are, under the Federal Reserve Act, divided up into twelve districts, each with a Federal Reserve Bank of its own;

and the co-operation of these twelve banks is secured by the provision of a Federal Reserve Board sitting at Washington, and possessing considerable powers of control over each of the Federal Reserve Banks.

Each Federal Reserve Bank is formed by banks in the district, who are called "member banks." All National banks must become member banks, and State banks are permitted and encouraged to join. The member banks subscribe the capital in proportion to their own capital; they are entitled to a dividend of not more than 6%, further profits going to the United States Treasury. They appoint three members of the Board, three others are appointed from the business men of the district, and three, of whom one is the chairman, are appointed by the Government.

The main provision for the control of the currency is to be found in the section of the Act which sanctions the creation of Federal Reserve notes. These are obligations of the United States and are receivable in payment of all taxes, customs and other public dues, but are not legal tender. Any Federal Reserve Bank may apply for such notes against collateral security consisting of "notes, drafts,

bills of exchange, bankers' acceptances, or gold or gold certificates." Each Federal Reserve Bank is required to "maintain reserves of gold or lawful money of not less than 40% against its Federal Reserve notes in actual circulation." No Federal Reserve Bank may pay out notes issued by another Federal Reserve Bank; such notes when received in the course of business must either be returned to the issuing bank, or paid direct into the Treasury of the United States in order to be retired.

All member banks are bound to keep with their Federal Reserve Bank their legal reserves, which must bear a specified proportion to their deposits, going up in certain circumstances to 13% of their deposits at not more than thirty days fixed, and 3% on deposits at longer dates. The Federal Reserve Banks themselves must keep 35% of their total deposits in cash; but provision is made for an elasticity of credit by the provision that the Federal Reserve Board may permit a temporary reduction below this limit on payment of an additional and progressive interest on the deficiency, so that it can practically only be used in the case of emer-

gency. This is analogous to the unwritten rule by which the British Chancellor of the Exchequer will only permit a "suspension of the Act" when the Bank Rate has been raised to 10%.

The full working of the Federal Reserve Act depends, it will be seen, largely upon the amount of good commercial paper bearing two names which the member banks can discount with their Reserve Bank in order that it may be put into the Treasury as a basis for the issue of Federal Reserve notes. One of the objects of the Act is to create an open discount market, in which bills can be borrowed upon. The importance of the discount market in London we shall see later on. Hitherto there has been but little dealing in bills in America. Banks were not allowed to accept, and acceptances for trade debts were for the most part only local in character. But earnest efforts are being made to extend this most useful form of negotiable credit, and considerable progress has been made.

Good commercial bills are the most available form by which the general supply of credit can be apportioned among the different

parts of the country according to their respective needs. The Federal Banks are prepared to discount for one another, and can indeed be compelled to do so in case of need by the Reserve Board. Thus it is now easy, when the Middle West requires cash for the movement of the grain crop, or the South for the cotton, for the Federal Reserve Bank at Chicago or Atlanta to send bills to the Reserve Bank at New York with a request that they be discounted. The cash is sent to the country districts, where the member banks use it to help the farmers with their wages or freight for their goods; and when the bills come due and are paid to the Reserve Bank in New York whose duty it is to collect them, the proceeds can be used against the shipment of the goods abroad. Against these goods bills are then drawn on foreign countries, which can be discounted, and so the supply of marketable bills is kept up, and the foreign exchanges are effectively worked.

Generally speaking the Reserve Banks have set up an efficient system of co-operation, and have reformed the distribution of credit and currency in a satisfactory manner. As the discount market grows in width and

elasticity the whole banking system should become more and more worthy of the United States.

But though the system has hitherto worked well, and undoubtedly saved the country from the serious financial crisis which, had it not been just established, must have attended the outbreak of the war and the entry into it of the United States, it does not appear to be wholly popular among the banks. Although the Federal Reserve Banks are the "bankers' banks," and as such do not ostensibly compete with the member banks, yet they have been given powers which do to a considerable extent interfere with the private interests of their constituents.

In the first place, though it was distinctly intended that they should have a large control over the general supply of credit in the country by means of their discount rates, which they could raise when they saw signs of a speculative expansion of loans, yet it was clear that a mere raising of the rate might not be sufficient to give them this control. They might raise the rate, but the member banks, so long as money was plentiful, as it generally is at the beginning of a speculative

boom, might go on lending at lower rates, so long as they were not obliged to borrow from the Reserve Banks. Power was given, therefore, to the Reserve Banks to make their rates effective by going into the market and selling their securities, thus bringing money from the market into their own reserves, and leaving less available for the banks to lend. This they seem to have used with much effect, in pursuance of the policy of the Federal Reserve Board to restrain any great rise in prices by keeping credit in check. Now a rise in prices brings an immediate profit to the speculator and through him to the banker; and it is only too easy to seek this immediate profit, regardless of wider interests. Hence it can be readily understood that the "open market policy" of the Reserve Banks has met with a great deal of unfriendly criticism. It may be noticed that this policy is rendered easy to them by the provision that they shall not pay the member banks, by way of dividend on their capital, more than 6% per annum, any surplus going to the United States Treasury. This is an indication to them that their policy is intended to be national and not sectional;

they need not hesitate to take steps which involve a loss of profit. And the "open market policy" does of course involve a loss of profit; for securities earning interest are sold in order that the proceeds may be locked up and remain idle; for if it were sought to make profit by re-lending, the policy would be stultified. The restriction of credit is not in any case a profitable or popular policy.

In another way the Federal Banks have adopted a policy which has produced serious criticism from the member banks. When cheques had to be collected by banks holding them in another town from that in which they were payable, the holding bank used to send them to their correspondents in the paying town, and a charge was made for collection. This charge was a considerable source of profit to the collecting bank. The charges differed in different districts, and it often was found a profitable practice to send cheques by roundabout routes for payment, in order to avoid some expensive town through which they would naturally have been passed. The Federal Reserve Banks deemed it their duty to bring all districts into proper co-ordination by abolishing these

transit charges, and set up a general clearing system by which all cheques throughout the country could be presented for payment free of cost. The banks who had profited by the commissions which were now no longer to be had naturally grumbled at this competition, and complaints are still loud. But there is no doubt that the general banking facilities of the continent have been materially increased by the new practice.

It is worth while to compare with the American system a yet later one which has had the most thorough discussion by the highest authorities both of Europe and America, namely, the German banking system set up under the Dawes Commission and subsequently modified by the Conference of London. As this scheme has been thoroughly considered and approved by the British Government and the Bank of England, it would seem that it indicates the lines on which the new Bank Charter for the regulation of our own note issue may be expected to run.

In the original Dawes Report the new German Bank of Issue was bound to keep not less than $33\frac{1}{3}\%$ of gold, or foreign

exchange, against its note issue, the balance being covered by approved commercial bills and other securities. It was also bound to keep a further special reserve in gold or gold securities of 12% of its deposit liabilities—this provision in effect seems to have been designed to correspond to our own division between the Banking and Issue Departments. Any drop below these limits was to be penalised by rapidly increasing rates of interest payable on the amount of the deficiency.

By the London Conference these very severe requirements were somewhat modified, and the new law now provides as follows. The Reichsbank has the right of note issue for fifty years, but the existing rights of the Würtemberg, Bavarian, Saxon and Baden Note Banks are reserved, their collective issues not to exceed 194 million marks—a quite small amount. The Reichsbank may make advances against gold and silver, certain Railway Bonds and Shares, State Certificates of Indebtedness falling due within twelve months, Bills and Commodities. All bills must regularly bear three names, instead of two required under the old system—in other words, purely commercial bills must be

re-discounted with the Reichsbank with the endorsement of a bank or other financial establishment, as the ordinary commercial bill bears only the names of the drawer and acceptor. The requirement of a third signature may be dispensed with in some cases for a limited amount. The amount of the note issue is to be covered by gold or foreign exchange up to 40%, of which three-quarters, or 30%, must be represented by gold. The remaining portion is to be covered by discounted bills and cheques satisfying specific requirements. Only in exceptional cases may the cover sink below 40% on consent being given by the General Council against, at the most, one dissenting vote. In this case the Bank has to pay on the difference arising on the 40% cover a tax as follows:

On a cover of between 37% and 40%	3% per annum,
On a cover of between 35% and 37%	5% per annum,
On a cover of between 33⅓% and 35%	8% per annum,

and a further 1% per annum on every 1% below the cover of 33⅓%. When the cover is below 40% the discount rate must be at least 5%. In case the tax is paid, the discount rate must be increased by at least one-

third of the percentage of the tax plus each increase of the aforementioned rates. That is, it would seem that if the tax of 3% becomes payable between the limits of 37% and 40%, the discount rate must be at least 5%, plus 1%, that is 6%, and increase till when the limit of 35% is passed the rate will be 5% plus $\frac{8}{3}$%, or $7\frac{2}{3}$% at least. This system of combined raising of the interest rate and the tax penalty should be completely efficacious. It may be added that up to the present the Reichsbank has gold in reserve well in excess of the amount required, the percentage on the 7th July, 1926, being 51·6%. The rate of discount, however, has ruled high, having only been reduced from 10% to 9% in February 1925, and from 9% to 7% in March 1926, then to $6\frac{1}{2}$% on 7th June and to 6% on 6th July, at which latter figure it at present stands.

It would seem then that when the time comes for our issue system to be placed on a sound footing, by the transfer of the Treasury note issues to the Bank of England, and the consequent entire remodelling of the Bank Charter Act, it will have to be on lines similar to those which have received such

authoritative approval from all the chief banking experts of the world. That is to say, the Bank will have the sole issue of notes; it will be bound to keep against the notes at least one-third of their amount in gold, with exceptional power to go below this limit on payment of a heavy tax, to be recouped from the borrowers who require the further issue by a still heavier bank rate for discounts. The remaining two-thirds of the issue will be against approved bills and other first-class securities, to be rigidly defined.

It was probably for considerations of this nature that the Treasury authorities, of course with the active support of the Governor of the Bank, decided, in accordance with the original proposal of the Cunliffe Committee, that it would be possible to return to the gold standard—*i.e.* to permit the export of gold, and its sale by the Bank at the standard rate—when the stock of gold amounted to £150 millions, while general conditions at the same time were such as to leave no doubt that the Bank could retain this stock by the normal operation of the bank rate. At the present time the stock is ample for conditions such as those outlined above. Taking at

random a recent date, it appears from the Bank return, and the report of the Treasury notes department, that on August 12, 1925, there were outstanding:

Currency Notes and Certificates . .	£301,216,000
Bank Notes in circulation	145,253,000
Total circulation	446,469,000

The amount of gold required to back this circulation to the extent of one-third would be £148,823,000, or close on the £150,000,000 proposed by the Cunliffe Committee. As a matter of fact, the Bank held at that date:

In the Issue Department	£162,434,000
In the Banking Department (say 50% of £1,822,000)	911,000
Total	£163,345,000

or over £14·5 millions more than the minimum needed. This would permit of the circulation of another £43·5 millions of notes before the limit was reached at which penal rates would come into play. So long as this proportion were maintained, the money market, which watches minutely the Bank's returns of the import and export of gold, would be in no apprehension of "dear money" or a rise in

the bank rate. But if gold began to go out to an extent which suggested an approach to the limit of £150 millions, anxiety would be aroused at once; the prospect of a rise in the bank rate would be brought near; and all those who deal in the discounting of bills would at once begin to raise the market rate in anticipation.

CHAPTER III

THE ENGLISH BANKING SYSTEM

THE Bank of England is the centre not only of the national finance, as the sole bank of issue and controlling the currency in partnership with the Treasury, but is also the centre of the general deposit banking system of the country, by its position as the banker of the banks, in which capacity it holds the ultimate reserve of the whole system of joint-stock banking. It has not only to keep the gold which serves as a backing to the note circulation of the land, but it also has to keep in hand the cash, in the form of notes and gold coin, which may be needed by the other banks to meet their liabilities in case of need. How it fulfils this function we have already seen in our discussion of the crisis of July–August 1914.

It is curious to us, as we look back, to see how reluctantly, and almost unconsciously, the Bank of England took up the rôle of the

bankers' bank, and how unwilling it was to recognise the responsibility which the position involved. Only little more than fifty years have passed since the publication of Walter Bagehot's *Lombard Street.* In 1873 Bagehot had to call attention to two things, first that "the Directors of the Bank are in fact, if not in name, trustees for the public, to keep a banking reserve on their behalf," and second that "so far from there being a distinct undertaking on the part of the Bank Directors to perform this duty, many of them scarcely acknowledge it, and some altogether deny it."

The opinion held by an important party among the Directors was that the Bank of England was simply a competing bank among other banks, and should be conducted as a dividend-earning business for the profit of its stockholders. For this purpose, it was said, no more money should be kept idle, in the form of a cash reserve, than the same proportion as that held by any competing bank. And indeed it was evident that it was on this proportion of reserve that the profits of the Bank mainly depended. Bagehot pointed out with irresistible logic that the smaller banks, by holding their reserves in

the form of a balance payable on demand with the Bank of England, could throw the onus of any sudden demand upon the Bank; and that unless the Bank kept itself invariably protected by a very large reserve in cash, the whole fabric of British credit rested on a foundation of the most precarious nature. He pointed out that the position of the Bank of England was wholly artificial. The natural development of banking would have led to the same outcome that had been reached in Scotland, where joint-stock banking had free scope since 1716, and where there had grown up side by side a number of banks of approximately equal power and great stability. In England the privilege given to the Bank of England by the prohibition of joint-stock banking had led to the concentration of all banking capital on the large scale into the hands of the Bank of England; the private banks were kept comparatively weak by the limitation of the number of their partners, and were therefore driven to rely entirely upon their great competitor in times of stress. Bagehot insisted that this special privilege imposed a corresponding duty which could not be shirked; and that the duty of the Directors of the Bank to the protection of

the national credit must take precedence of the rate of dividend to be paid on Bank stock. His masterly essay convinced public opinion; and since its appearance there has been no further question. The Bank has loyally shouldered the responsibility placed upon it, and has maintained its reserves at a point which enabled it to face without any recourse to Government help the various emergencies which threatened the national credit from 1866 to 1914.

It is noteworthy that there appeared at about the same time another outstanding essay which pointed out the manner in which the Bank should maintain its reserves of gold. Goschen's *Theory of the Foreign Exchanges* appeared in 1860, and indicated the power which the Bank had of attracting gold from abroad by means of the bank rate. In particular Goschen pointed out, what had never before been recognised in practice, that when it was desired to affect the foreign exchanges it was necessary that the bank rate should be altered by steps of 1%, and not ½% as had previously been the practice. These two remarkable books, in fact, between them have been taken, ever since their appearance, as the foundation of the policy of the Bank of

England in its dealings on the banking side of its business.

The position of the Bank in our system is thus essentially two-sided. On the one hand it represents the national interests. It is the Government Bank, it holds the Government balances, it makes advances to the Government from time to time, it issues Government loans and maintains the service of them, keeping the registers of stocks and paying the interest. The Governor is in constant touch with the Chancellor of the Exchequer, and is the medium by which the financial policy of the Government is conveyed to the City for execution. Under the existing system of issue (if it can be called a system) the Governor is responsible for maintaining a certain amount of gold backing for the Treasury note issue, while at the same time he has to maintain also an adequate reserve in his Banking Department for any calls that may be made upon him by the market in times of stringency. Roughly speaking these are the duties of the Bank to the public.

On the other hand the Governor and Directors of the Bank owe a duty to their stockholders, for whose account they carry on the business of a deposit bank. They

accept from the public deposits payable on demand by cheque—our definition of a banker; they lend money to their customers and on the money market by the discount of bills or by loans against approved securities, and they render most of the small services for which people now look to their bankers. And on this they make a profit which is at least sufficient to pay a steady dividend on Bank stock. The Bank of England paid in dividend 9% from 1904 to 1913; 10% from 1914–15 to 1920–1; 11½% in 1921–2 and 12% from 1922–3 to 1924–5. What the real profits of the Bank are is a secret which is never revealed. No Profit and Loss Account is ever published; the minimum limit of the "Rest" or undivided profit stands at the same figure, £3,000,000, as it did in 1844, and additions are made to it week by week at a rate which will, at the end of the half-year, allow of the payment of the dividend without any drop below the fixed minimum. The only glimpse the public have had into the question of real profits was in the announcement that the Bank had decided to present to the Government a sum representing the extra profits made on the conduct of the Government account during the war. It may

safely be guessed that "hidden reserves" provide a handsome item to be included among the "Other Deposits."

On the banking side, the Bank of England does no doubt to some extent compete with the joint-stock banks, and it has sometimes formed a source of complaint that their balances should thus be used in competition with them. But for this there is little or no ground. A large part of the bankers' balances is, in fact, not used at all; it is kept idle, earning nothing, in order that it may be at the disposal of the bankers when wanted. And the service which the Bank thus renders far outweighs any loss of business—not considerable in any case—which may be attracted to the Bank of England from the other bankers.

Experience too has taught the joint-stock banks to accept willingly the leadership of the Bank of England wherever national interests are concerned. At one time indeed the relation was not that of willing co-operation. Up to the war the Bank of England was very much disposed to stand on its dignity, and to keep the clearing banks at arm's length. During the first eventful days of the outbreak of war, in the Bank Holidays of August 1914, the clearing banks found

themselves in a difficult position because, while anxious to co-operate with the Bank of England and the Government, they were excluded from all knowledge of the lines on which public policy was being shaped, and the Bank declined to send any representative to attend and instruct the joint meetings of the clearing and country banks which were being held every day. But the necessities of the case, and an enlightened control at the Bank, soon remedied this awkward state of things. On the one hand, a "Treasury Committee" of the bankers was formed, and kept in touch with the Chancellor of the Exchequer; on the other, the Governor of the Bank made it his practice to maintain constant relations with the Clearing House Committee. These relations are still kept up, and, though the clearing bankers are of course never consulted on such matters as the alteration of the bank rate of discount, conferences on many matters of common interest still take place at frequent intervals, and the "Treasury Committee" is still the official channel of communication between the bankers and the Chancellor.

Another change due to the war is the fact that the Bank of England has for some time

been the custodian of the bulk of the gold in the country, the other banks having agreed to hand over to it, at the request of the Treasury, all the gold coin that comes into their possession. The Bank is thus better equipped than it was before the war to protect the gold reserves, because it knows just where and what they are. Until the war, the amount of gold in the country was a matter of guess-work; and it was only the appeal made during the war to all who had gold in their possession to exchange it for Treasury notes which enabled the banks to take stock of the real position. It should, however, be added that quite recently, in the spring of 1926, there have been some signs of a departure from this practice. The joint-stock banks have not been called upon for some time to hand over the coin which still dribbles in to them from the country, and there have been cases in which gold has been bought by one at least of them in the open market.

It must be noticed that, while the Bank of England competes with the joint-stock banks by keeping current accounts with trading firms and individuals, it makes it a rule not to take deposit accounts for short dates at

interest. It is largely upon the absence of competition in this respect that the London banking system was enabled to establish itself by the side of the Bank. By offering interest on deposit accounts at seven days' notice the joint-stock banks are enabled to attract large funds which they can safely lend again for short periods. This again will come up for consideration when we are dealing with the money market. One of the most momentous departures from precedent made by the Bank during the war was the allowance of interest to the joint-stock banks for short money. This gave the Government complete command for the time over the money market. It was, however, adopted strictly as a temporary war measure, and was withdrawn shortly after the war, in July 1919.

Grouped round the Bank as a centre stand the large joint-stock banks engaged primarily in the home business. These include not only the London clearing banks, among them the "Big Five," but a group of banks in Manchester who have resisted the tendency to amalgamation with London banks, and form an independent group of their own, though one is affiliated, by the purchase of shares, to a London clearing bank.

With the nature and functions of the London Clearing House we shall deal later on. Outside the Clearing House system stand the Scottish banks, carrying on their business under Scots law, but, of course, in close touch with London through their offices there. In some cases the shares in the Scottish banks also are owned by London banks. The same is the case with some of the Irish banks, though here the attitude is more independent. The Irish banks, like the Scottish, have their own right of issuing notes, which in both countries form the bulk of the currency, though the quality of legal tender conferred on them during the war has since been withdrawn.

With these London and country banks are closely linked the group known as the Overseas banks, under which name they form an Association for the purpose of watching and discussing their common interests. They comprise two main classes: (1) the Colonial banks, some of which have their head offices in London, while others have their head offices in the Colonies with subordinate London offices; (2) the "Exchange banks" dealing chiefly in the financing of trade between Great Britain on the one hand and India and the extreme East on the other. Here, again,

some have a head office abroad, notably the Hongkong and Shanghai Bank, which has its seat of Government in Hongkong, but a very important office and committee in London. The Overseas banks have joined with the deposit banks, English, Scottish and Irish, to form the British Bankers' Association for common discussion.

Outside the British Bankers' Association are the foreign banks which have London offices. The most important of these are French and American banks, some of whom do a large business and at times lend or borrow considerable sums on the London money market. The first place before the war was taken by the German banks. These were, of course, closed, and their London accounts liquidated during the war; and there has been so far no attempt on their part to return to London. The business which they did has been divided up among London houses in a way which we shall have to mention when discussing foreign banking. These banks naturally do not form part of the British Bankers' Association.

The above classes comprise all the institutions which are generally recognised as banks in London; but the banking system would

not be complete without the inclusion of at least two other financial groups, which indeed form most essential elements in the highly specialised London money market. New York is at present engaged in introducing them across the Atlantic, recognising that their absence hitherto has been a serious impediment to the growth of that market as a centre of world finance. These two groups are the Accepting Houses and the Discount Houses.

The first group are separated from the banks proper only by a very fine line. They are indeed also known as "Merchant Bankers," a title which closely indicates their functions. On the continent of Europe they would be regarded as typically bankers. In London, however, they have organised themselves as a distinct group with their own association, the "Accepting Houses' Committee." But one of them at least has quite recently absorbed an allied Overseas bank, and now calls itself a bank in its official title. Most of the Accepting Houses are, however, private businesses, working on their own capital, and not "holding out" that they take money on deposit payable on demand by cheque. They make a speciality of the financing of international trade, which is shared by the joint-

stock banks; but in practice their spheres of influence are fairly well marked off, and there is little interference. A special chapter will be devoted to a discussion of their work.

The next group exercise also a highly specialised function. The discount brokers play a very important part in the London market. Here again their particular business, the discounting of bills, might seem to clash with the work of the banks proper; for it has, at all times, been the practice, and indeed an elementary duty, of banks to discount bills, and they do so on a large scale for their own customers. But it is in practice found to be worth their while to depute this work to a very great extent to the specialists, lending them money to be re-lent in the discount of bills. The discount market will again need a fuller discussion later on.

And finally, we must not leave out of sight the Stock Exchange. This is not strictly speaking a part of the banking system; but it is very closely linked with the banks by the custom of making short loans against stocks, generally for a fortnight, "from account to account." This is not only of material assistance to the members of the Stock Exchange, but offers the banks a very

convenient outlet for money which they do not think it wise to lend out for more than this short period.

We will now, after this brief view of the English banking system, proceed to discuss in greater detail the various members of it.

CHAPTER IV

DEPOSIT BANKS

Round the Bank of Issue, the centre of the whole banking system, are ranged a group of Banks of Deposit which carry on the distribution of credit. These may be numerous and individually comparatively small, as in the United States, or few and very large, as in England, France and Germany. But their functions are largely analogous. The fact that within the last few years deposit banking in England has been concentrated into a small number of large banks has focussed the public view upon them to a disproportionate extent, and produced a very exaggerated idea of the functions which they carry out and of the power which is in their hands.

In the first place it must be pointed out that the main credit system of the country is outside their sphere of influence. They have little or nothing to do as owners with the constant volume of credit which is kept afloat by the aggregate capital of the trading con-

cerns of the country—the standing amount which all industrial and commercial businesses, from the producer to the retailer, carry on their books as an asset in the form of debts due to them, the credit given by the manufacturer to the merchant, by the wholesale dealer to the retailer, by the retailer to his private customer, or in holding their normal stocks of raw materials and goods, manufactured or in course of manufacture. Nor, again, are the banks connected with the great capitalisations of industrial companies. They are not, except incidentally, owners of the shares or debentures by which the industrial and commercial companies obtain credit from the public. The banker holds aloof from all kinds of capital investment. He may give his services in issuing a loan to the public, or he may take debentures and other securities in pledge as security for loans; but he uses caution in taking shares as security, and if they are not fully paid up it is likely that he may decline them. It may then be said that the main credit system of the country, the gigantic amount carried by trade in the form of capital or capital debts, is independent of the banker altogether.

The banks deal, in fact, only with the bare

fringe of this great mass of credit, the result of centuries of thrift and of profits put into the stock of the country's capital. A manufacturer of table mustard is reported to have said that he lived entirely on what people left on their plates. In the same way it may be said that the deposit banks live entirely on capital that people do not want at the moment. No business of any extent can foresee exactly from day to day what calls may be coming in, or what opportunities for favourable purchases may suddenly present themselves. Even a small household wants a certain amount of "loose cash" for housekeeping purposes. It is with this floating capital that the banker deals, and on it his business is entirely founded.

Deposit banking grew, as we have seen, out of the need of a safe place of deposit. The obvious risks of hoarding coin for current needs in troublous times led the holders to look round for those who were accustomed to the custody of precious metals, and knew how to deal with them. In London they went to the goldsmiths. The goldsmiths gave them "goldsmiths' notes" in the nature of deposit certificates, and these as they became familiar, passed from hand to hand, and

served for currency as representing a similar amount of precious metal held in safe custody by responsible persons. The goldsmiths, provided they accepted money repayable only after a certain term, could obviously make a profit on the deposit by re-lending it, so long as they in their turn could stipulate that it should be repaid to them before the original deposit became due; they thus assured themselves that they would be in funds to meet their depositor's demand at the due date. It then became possible for them to allow their depositor a rate of interest on his deposit, less, of course, than that which they could obtain by lending; the difference between the two rates constituted their profit, that is, their recompense for their services in giving safe custody on the one hand and meeting the requirements of the borrower on the other.

Of course the goldsmith had to depend on his judgment in giving credit, and was bound to take proper security for his loan. Unfortunately the goldsmiths, trusting to the word of the King, made large advances to Charles II; and the monarch, true to his character, did not hesitate to repudiate his obligation as soon as he found it convenient to do so. The consequence was that "gold-

smiths' notes" could not be redeemed; payment was suspended in 1672 and great distress was caused. A shock had been given to deposit banking which it took some time to get over. Yet the advantages of the arrangement were so patent that the idea was not only re-established but extended. The goldsmiths found by experience that they could take deposits withdrawable not at a fixed future date, but at any time at the will of the depositor, with confidence that, if such deposits were on a large scale, a sufficient proportion of them would always be left untouched for a certain period to enable the holder to lend up to something like that proportion. This became the foundation of the "current account," on which the depositor might draw at will. One thing further was needed—the invention of the cheque, by which drawing on the current account was facilitated. When the cheque had come into general acceptance, as a negotiable instrument which could be passed from hand to hand, the system of deposit banking was established, and has gone forward with steady development to the present day. It is essentially a London invention. It was by basing their business on the double system of the

current account and the deposit account that the London goldsmiths developed into bankers. They were able to do so under the shelter of the Bank of England, because the Bank did not compete with them for deposits at interest.

The deposit banker's business depends on two conditions. First there must be persons with spare cash which they do not need for the moment, which they are prepared to put on deposit, for a certain consideration; second, there must be people who are in need of money, and are prepared to repay temporary loans within a short period. The banker deals in "short money" on both sides. He is essentially a broker whose business it is to link up money needing temporary investment with borrowers needing temporary loans.

It is important to insist upon the fact that the banker's business is founded on his deposits, and limited by them, because a fashion has grown up lately of regarding the joint-stock banks as "creators of credit." They are, of course, creators of credit in the sense in which every lender, even the kind-hearted man who gives a "little loan" of *5s.* to a needy friend, is a creator of credit. But this is not what is meant. By using an ambiguous phrase it is meant to imply that the "banks,"

meaning the joint-stock banks, can increase to an unlimited extent the amount of credit current. In this sense the idea is plainly untrue. The State is a creator of credit in that sense, because it can not only create paper currency to an unlimited extent, but by making it legal tender can force it into the hands of everyone to whom it owes money. But this power, as we have seen, has been withdrawn from all banks in England. The banks can lend no more than they can borrow —in fact not nearly so much. If anyone in the deposit banking system can be called a "creator of credit" it is the depositor; for the banks are strictly limited in their lending operations by the amount which the depositor thinks fit to leave with them.

It has indeed been argued that every loan by the banks creates a deposit; that so long as the banks go on increasing their loans, so long will their deposits grow in the same degree, and that thus the banks can be regarded as creating credit. Unfortunately this theory will not stand confrontation with facts. Reference to Table A (below) will show at once that the course of events in the first half of the year 1925 gives a decisive answer to this hypothesis. The months in question

show a marked growth in the item of Loans and Advances to Customers, amounting in the aggregate of the "Big Five" balance sheets to as much as £29,525,000.

TABLE "A"

AGGREGATE AVERAGE WEEKLY FIGURES OF "BIG FIVE" FOR FIRST SIX MONTHS OF 1925

	Current and Deposit a/cs.	Loans and Advances.	Discounts.	Investments.
	£	£	£	£
January . .	1,514,631,000	745,859,000	235,289,000	266,501,000
February . .	1,502,293,000	748,639,000	225,172,000	258,071,000
March . . .	1,470,692,000	765,443,000	195,239,000	254,316,000
April . . .	1,472,197,000	771,461,000	184,024,000	249,646,000
May . . .	1,466,779,000	773,257,000	192,884,000	246,680,000
June . . .	1,489,848,000	775,384,000	197,929,000	240,422,000

But this great increase in advances was accompanied not, as should have been the case according to the theorists, by a corresponding increase in the money lodged, but by a large decrease. All the banks, in order to meet the additional call upon their resources, resorted not to any "creation of credit," which was out of their power, but to their investments at long date, that is, their Government stocks and bonds, which were sold to provide the money for which the borrowers were asking. In other words, the

creation of credit in one direction is only made possible by a corresponding cancellation of credit in another; the banks can only lend more to their customers by lending less to the Government.

The deposit banks may be looked on as an elaborate lubricating system, designed to keep the machine of industry in good going order. Every business, and indeed any individual, needs to have a certain amount of loose capital, and in addition successful businesses and thrifty individuals are always, especially in time of prosperity, but also, to an extent not often realised, in what are called "bad times," accumulating reserves of savings. In the latter case the savings are held in hand temporarily, awaiting a good opportunity of permanent investment. The demand for loose capital varies from time to time, from business to business, and from place to place. For whatever reason, the supply of loose capital is always there; the function of the deposit bank is to bring the two together, to take away the superfluous lubricating oil where it is running over, and carry it to the point where it is wanted at the moment. The banks have to follow the currents of trade and production; they have no means of con-

trolling them. They are the servants, not the tyrants of industry. The great bank amalgamations of recent years have been only steps in the perfection of the organisation for "piping" the country together. Some districts are generally provided with a superfluity of loose capital, others are short of it. The banks have now spread their branches throughout the country in a manner which makes them extraordinarily sensitive to the needs and the resources of each district. Not so long ago it was easy for a bank in a district hungry for loans, such as the great manufacturing centres generally are, to find the demands beyond the resources at its command. It had the choice of either "getting over-lent," to the damage of its liquidity, and possibly even of its credit, or of letting good business go by. This is the chief consideration which has gradually forced the small local banks into the great combinations which now conserve and distribute the liquid capital of the whole country.

The banks have to compete with one another to obtain the deposits which form their base of operations. It has already been pointed out that these are of two kinds, deposits on current account and on deposit account. The

latter are for a definite period, which is a matter of arrangement between the depositor and the bank. There is, however, one important exception. A very common period of deposit for London and the home counties is "seven days' notice," *i.e.* the money is deposited on the understanding that it can be withdrawn by giving seven days' notice; but it is also a usual condition that it shall remain at least a month on deposit before notice expires. The rate for seven days' money is what is usually called the "Bank deposit rate." It is fixed for London by a meeting of the clearing bankers held immediately upon any change in the Bank of England rate of discount, and it depends directly on that rate. Before the war it was regularly fixed at 1½% below the bank rate. Thus when the bank rate was 2%, as it was for the greater part of the period from February 1894 to September 1897, the bank deposit rate was ½%. When the bank rate was 5% the deposit rate would be 3½%, and so on. But during the war a new practice grew up, and for some years now the deposit rate has been fixed at 2% below the bank rate. This, of course, means that the banks are obtaining a larger margin of profit between the rate they

are paying to their depositors and that which they are charging to lenders. The reason is that there has been a great increase since the war in "overhead" expenses, salaries and the like, which have to be met by a similar increase in the banker's "turn" on his transactions.

It must be noticed that this deposit rate only applies to the "Metropolitan area," the City and County Council district, though in practice it is used over most of the home counties and south of England. It has, however, a less precise application to the main industrial regions of the Midlands and north. Here by tradition the rates for deposits do not vary so directly with the bank rate. This is a relic of the old division between country banking and London banking to which attention has already been called. But though the effect of the deposit rate is thus limited, it is of great importance as affecting the value of money in the "money market" of London. To this we shall have to recur later.

With regard to the treatment of current accounts there is a similar difference between London and the country, dating from the days when deposit banking was growing up in

London beside the issue banking of the country. In London it is the general custom not to allow any interest on current accounts. The bank gives its services in keeping the account in consideration of having the use for nothing of a certain "free balance." The amount of this is fixed roughly at a sum the interest on which will about cover the cost of the account; and this again is roughly estimated on the number of cheques passed through it in the course of the year as indicated by the number of pages in the ledger taken by the account. If a free balance is not kept sufficient to provide in interest the cost of keeping the account, the banker will naturally require to be remunerated by charging a fixed commission on the turnover of the account.

In the country it is usual to allow a fixed small rate of interest on the whole of the current account, while charging by way of remuneration a fixed percentage on the turnover, however large. This is purely a matter of tradition But it must be borne in mind that it is not quite correct to speak of allowing no interest on the current account as the "English practice"; it is, in fact, the London practice. And even in London it does not

apply to the balances kept by foreign banks with London banks. Interest is always allowed on the full amount of these. The rate is now usually agreed between the banks when they meet to settle the deposit rate. The agreed rate used to apply to all "foreign money" (*i.e.* sterling balances maintained by foreign banks with London banks) not fixed for more than thirty days. This term has been recently reduced to fourteen days. For all money fixed for longer periods each bank can make its own terms, and competition is very severe.

It is, however, not only by the offer of interest that the banker seeks to attract deposits. He is ready to perform many other services for his customers, and many of these he is willing to perform gratis. The most important of these is the custody of valuables other than cash. This may be divided into two parts—the custody of marketable securities, and the custody of boxes and similar parcels.

The custody of securities is a regular part of the business of every branch. It includes not only the safe-keeping of the documents which represent the investments, the share certificates, the bonds, deeds of property,

and so on; but to this duty is in many, probably most, cases added the task of collecting the interest in cases where it is not paid in automatically. This is particularly the case with bearer bonds, a form in which a large proportion of our foreign investments is held. The interest on these is represented, as a rule, by coupons which have to be detached from the bond and presented for payment at the paying office. This is a task which is difficult for the private holder to perform, and which is a simple matter of routine for the banker. In addition to these a watch has to be kept on announcements of bonds "drawn," where they are liable to be drawn for repayment. The banker endeavours to keep an eye on the lists of drawn bonds published in the papers, and see whether any of those which he holds for account of customers have to be presented and paid off. Similarly other securities may have to be converted or exchanged, and the banker is looked to for the detailed execution of such transactions. The banker also is prepared to arrange for the sale or purchase of securities through a stockbroker, in that case sharing the commission with the broker. And

generally speaking it is expected of every bank manager that he shall be prepared to obtain expert advice and information for his customers on all matters of investment and finance. The bank has to rely entirely upon the tact and judgment of each manager in this respect; a heedless word may involve serious loss, if not in money, at least in reputation.

In giving custody to parcels and boxes, sealed and locked, with contents unknown, the banker is not without anxiety. The risk he runs may be illustrated by an incident which occurred some years ago. A lady deposited a locked box with her bankers, contents unknown. One day a man appeared with an order signed by the lady directing that the box should be given up to him. The bank accordingly gave up the box. After a time the lady came and asked for it, and was told that it had been surrendered on her order. The lady showed that the order was a forgery; she stated that the box contained her jewellery of the value of some tens of thousands of pounds. The bank satisfied themselves that the order was forged; they were advised that they had no defence to the claim, and paid a

large sum in compromise on the simple declaration that the contents of the box were of a stated value.

The fault of the bank lay, of course, in their not recognising the forgery. But even apart from forgery the bank runs risks, for instance from theft. When a bank accepts parcels for safe custody, if it makes a charge for its services it is undoubtedly liable if they are lost. If it makes no charge, it claims that it is what the law calls a "gratuitous bailee" and incurs no liability so long as it guards its customer's property with due diligence, which practically means if it guards them as carefully as it guards its own property. The generally accepted definition of the duty of a gratuitous bailee is as follows: "He is bound to take the same care of the property entrusted to him as a reasonably prudent and careful man may fairly be expected to take of his own property of the like description." But the legal point has never been settled, and it would be difficult in fact, even if possible, for a bank to disclaim liability. But the risk has to be taken in most cases, and this particular form of accommodation is a very material addition to the services which the bank undertakes on behalf of its customers.

It may be as well to mention at this point a few of the other miscellaneous services which a bank will now render, though in most cases it makes a charge. It will give guarantees for all sorts of risks in cases where it is satisfied of the position of its customers; for instance, it is continually called upon to give guarantees for the issue of new certificates for shares where the original is said to have been lost or destroyed; it guarantees the delivery of documents such as bills of lading where they have been delayed in the post and the delivery of goods is required. All the large banks now have departments which will undertake trusteeships, the executorship of wills, the administration of family trusts and the like. This is a comparatively new business, but is rapidly growing. Again, departments are established to assist customers in making income tax returns and claiming exemption—a region in which expert assistance is much needed in dealing with all the complications of recent tax legislation. A bank is often used as a business address by customers who are abroad or frequently have to change their residence at home. American banks in particular make a feature of the "Travellers' Departments" opened by their European

agencies and branches; and it may be noted that a considerable responsibility and risk is involved in the task of correctly re-addressing and forwarding letters; any mistakes such as the omission to forward letters containing valuables or documents of importance may lead to serious claims.

When the banker has inspired confidence in the public by his record and reputation—which count, of course, far more than the amount of his capital—and has made clear to them the nature of the services he is prepared to render them, whether by paying interest on their deposits or in other directions, he can reckon upon their deposits flowing in. He will indeed have to reckon with the keenest competition from other banks of like standing with his own; but this competition has now reached a point where there is little or no room for further concessions to the public; and business has to be attracted mainly by approaching the customer in the most literal sense—by placing a branch of the bank as near his front door as possible. Good and well-situated premises are the best and most indispensable advertisement for a bank; but they are a very expensive advertisement. Before the war it used to be calculated that a

branch in a well-chosen spot ought to be paying its way in from three to five years. Since the war, owing to the growth of "overhead" expenses in general, not only salaries, but cost of building, of postage, of stationery and all the thousand and one details of daily expenditure, the time before the paying stage may be taken to have doubled. Yet the competition between banks in the opening of new branches has been keener than ever since the war. Each of the "Big Five" banks has taken the whole country as its domain. There is no more that sense of friendliness which impelled the smaller banks of old to abstain from poaching on territories which were marked out by tradition as "belonging" to particular houses. At most, the practice of touting for customers of other banks is disapproved; yet complaints often arise. The banks often meet to discuss matters of common interest, whether the London banks at the Clearing House Committee, or British banks in general at the British Bankers' Association, which includes Scottish, Irish and Overseas banks. The clearing banks also fix the "deposit rate" of interest, which always depends on the bank rate, and applies only to the City and County of London. But

beyond these limits it can be confidently said that there is no understanding, secret or other, between the banks; there is nothing of the nature of a "money trust" or combination to exploit the public. The public has the benefit of competition between the banks in its fullest form.

CHAPTER V

A BANK BALANCE SHEET

We have now reached a point at which it is well that we should have before us a typical Bank Balance Sheet, and go seriatim through the items of it, pointing out their meaning, and showing what conclusions can be drawn from them. Now that the large joint-stock banks have agreed upon a common form for their monthly statements, it is easy to combine the different statements into one, and I have therefore drawn up, in the form of Table "B," a composite balance sheet, in which the statements of the "Big Five" banks for the end of February 1926 are averaged.

We will begin with the left-hand side of the balance sheet. The first item, "Capital paid up," forms, in most cases, a part only of the total capital on which the credit of the bank, at least in theory, rests. Generally speaking a bank has a considerable uncalled capital in addition to the amount paid up. But this

TABLE "B"

Composite Balance Sheet

Liabilities.		Assets.	
Capital paid-up	£12,232,000	Coin, Bank and Currency Notes and Balances with Bank of England	£34,647,000
Reserve Fund	10,089,000	Balances with and Cheques in course of collection on other Banks in the United Kingdom	8,669,000
Current, Deposit and Other Accounts	295,087,000	Money at Call and Short Notice	19,736,000
Acceptances, Endorsements, etc.	19,089,000	Bills Discounted	40,038,000
		Investments	45,835,000
		Advances to Customers and Other Accounts	158,304,000
		Liabilities of Customers for Acceptances, Endorsements, etc.	19,089,000
		Investments in affiliated Banks	4,949,000
		Bank Premises Account . .	5,230,000
	£336,497,000		£336,497,000

uncalled capital forms no part of the composite balance sheet. There is, of course, considerable variation between the banks as to the proportion of their unpaid capital to the part paid up. Some of the unpaid capital is also held in the form of "Reserve Capital," which is only callable in the event of liquidation. But generally speaking it may be said that less and less stress has been laid on uncalled capital as the banks have grown in size and have been able to publish large additions to their reserves. The public are rightly convinced of the intrinsic strength of the great banks, and the question of a recourse to uncalled capital has ceased to have any appreciable influence on the credit of a bank, except so far as the market value of its partly paid shares is slightly depreciated by the nominal risk.

The bank must none the less be founded on a solid capital. Half a century ago the shareholders in a bank were full partners, liable up to the whole extent of their personal fortunes for any deficiency in the amount required to pay off the depositors on the liquidation of the bank. It was supposed that nothing short of this would give the security which depositors needed before they would entrust

their money. The principle of limited liability was not legally made applicable to joint-stock banks till 1858; the only exceptions up to that date were the Bank of England and the three oldest Scottish banks, which had been granted the privilege by special Acts or by Royal Charter. And for another twenty years it was regarded as an axiom that unlimited liability was essential for the credit of any ordinary banking company. But the appalling failure of the City of Glasgow Bank in 1878 opened the eyes of investors to the terrible risks which they ran in holding bank shares with unlimited liability. Under that liquidation every shareholder, with the exception of a few very wealthy men, had to surrender all his fortune in order to meet the demands of the depositors; many innocent persons, who might not even know that under some trust they were registered among the owners of a few shares, were reduced to poverty. Bank shares were for a time almost unsaleable, and it became clear that the business of joint-stock banking would be disastrously crippled unless the principle of limited liability were introduced. In a short time every joint-stock bank in the kingdom had taken advantage of the Act of 1858.

Fearful of their credit, the banks in all cases reserved a substantial amount of uncalled liability, and in some cases at least increased their paid-up capital. In fact the banks were at that time generally over-capitalised, and the effect of progressive amalgamations has been on the whole to decrease the proportion of capital to deposits. Before the war the proportion of paid-up capital and published reserves together to deposits stood at a little over 10%. During the war and the consequent inflation deposits rose enormously, while capital was hardly if at all increased, and the proportion fell to about 6%. Since 1921 and deflation the deposits have fallen off, there has been some increase in capital, and the proportion has risen to 7% or 8%. But it is noticeable that the tendency has been to issue new capital in the form of fully paid shares, so that the proportion of uncalled capital has fallen. One big bank indeed has ingeniously contrived to convert its whole capital into fully paid shares, without any obviously bad results. Published reserves, the result of savings from profit in the past, are generally kept about equal to the paid-up capital; and it is, of course, known that all the large banks have large hidden reserves in

the form of contingency funds and the like, though the amount of these is not revealed. Generally speaking it may be said that the present capitalisation of the banks is recognised as sufficient for all practical purposes.

The next item, "Reserve Fund," is to all intents and purposes part of the capital of the bank. It represents an accumulation of profits which have been earned but not distributed, and which belong to the shareholders, like the "Rest" in the Bank of England returns. It is, of course, within the power of the banks to draw upon the reserve fund in the case of need. Such a thing has been done in the past; instances occurred some thirty years ago, when a great fall took place in the value of Consols, in which many banks had largely invested their reserve funds. But it is exceedingly unlikely that any recourse will be had again to such expedient; all banks have so strengthened themselves by inner reserves that recourse to a published reserve would create an alarm which would seriously damage the credit of a bank in need of it. For all practical purposes, therefore, we take the Paid-up Capital and Reserve Fund in combination as representing the capital of the bank.

It will be seen that these two lines together in the composite balance sheet amount to £22,321,000, or 7·56% of the Current, Deposit and Other Accounts. None of the banks depart widely from this percentage. Barclays, whose capital is fully paid up, compensate for this by showing 8·3%; the others only vary between 7% and 7·86%.

It must not, however, be overlooked that the percentage of capital to deposits is affected by the extent to which the large banks have affiliated other banks to themselves by the purchase of shares. To this practice we shall recur at a later point. But it must be mentioned here that the paid-up capital of the owning bank has to form the foundation for the credit of the affiliated banks as well as its own. If we take into account this addition to the total deposits, the percentage of capital to liabilities to depositors is reduced as follows:

In the case of Barclays Bank	from 8·30% to 7·16%
In the case of Lloyds Bank	from 7·39% to 5·83%
In the case of Midland Bank	from 7·50% to 6·23%
In the case of National Provincial	from 7·86% to 7·05%
In the case of Westminster Bank	from 7·04% to 6·38%

NOTE:—The percentages in the above table are as at end December, 1925, or as near as possible thereto. Capital is taken as "Proprietors' Funds," *i.e.*, Capital, Reserve and Carry Forward.

On the average of all five banks, this means a reduction from 7·61% to 6·48%.

We pass on to the next line, "Current, Deposit and Other Accounts." So far as this is represented by Current and Deposit Accounts, it speaks for itself; it includes the whole liability of the bank to the public, as distinct from its liability to its shareholders. The proportion of current to deposit accounts is a varying one. It varies in different parts of the country and at different times. In Scotland and Ireland the amounts kept on deposit largely exceed those on current account. In England as a rule the contrary is the case, and current accounts are in excess. But this is largely dependent on the bank rate, which controls the deposit rate of interest. When this is high, everyone is inclined to put as much of his spare cash to earn interest on deposits as his banker, or his conscience and sense of duty to his banker, will allow. When the deposit rate goes up to about 3½% or over, there seems to be a notable tendency on the part of deposit accounts to overtake current accounts; and this is one reason why bankers do not look with any favour on a high bank rate.

But "Other" accounts do not thus speak

for themselves. Included in these are sundry items which the banker deliberately abstains from setting out. Prominent among them is the important item of hidden reserves, including whatever provision has been made for bad and doubtful debts, for depreciation of investments and for various funds of the nature of insurance against eventualities which every prudent banker keeps in hand. Moreover, there are wrapped up under this head, to be produced only at the annual stocktaking, the profits which are accumulating during the year. And there are also wrapped up many items of internal bookkeeping, often set off against corresponding items in the "Other Accounts" which follow "Advances to Customers" on the opposite side of the balance sheet. Some of these we shall have to mention presently. It is enough now to point out that when a banker is keeping in hand his cash reserves on a certain percentage of his "Current, Deposit and Other Accounts" he is really keeping a materially larger percentage of his actual liabilities to the public.

There remains to be considered the line "Acceptances, Endorsements, etc.," which must be taken into account with an equal

"contra" item on the other side of the balance sheet. With the meaning of the acceptance proper we shall have to deal presently; they are an all-important factor in the financing of overseas trade, and are the one means left to the banks by which they can "create credit"; the joint-stock banks in England having long lost the privilege of issuing bank-notes payable to bearer on demand.

As two "contra" accounts do not affect the ultimate balance of the balance sheet, it is evident that they are inserted only for the purpose of giving information. But it must be said that, under present arrangements, they give as little information as possible and very few deductions of any interest can be drawn from them.

In his speech at the Annual Meeting of the Midland Bank Limited on January 25, 1924, Mr. McKenna, in dealing with this particular item in the balance sheet, said:

"The impression that trade is improving is confirmed at first sight by the notable increase in our acceptances and engagements on account of customers, but here I must warn you against a hasty conclusion. Our acceptances and engagements now stand at

£36,552,607 as compared with £25,862,341 at the end of 1922, but the greater part of this increase is due to a rise in engagements resulting from the growing volume of business in forward exchange. . . . As it is our invariable custom to protect ourselves against loss by a compensating purchase or sale, it is necessary for book-keeping purposes to include under our engagements two entries in respect of a single transaction."

The practice of the Midland Bank referred to above in Mr. McKenna's speech is not, however, common to all the members of the "Big Five," the more general method being to take into account the difference only (if there be any) between the Bank's Forward Purchases and its Forward Sales, such difference being reflected in the balance sheet by an increase or decrease in cash, against a corresponding increase in one or other of the following items:

(*a*) "Current Deposit, and Other Accounts"—where Forward Purchases exceed Sales;

(*b*) "Advances, etc."—where Forward Sales exceed Purchases;

the total of Acceptances, Endorsements, etc. not being in any way affected.

There has been no agreement between the banks as to the composition of this item—Acceptances, Endorsements, etc.—and in fact very great differences in practice are known to exist. The existence of differing methods of accountancy—that relating to Forward Exchange Contracts, to mention one item—renders impossible, as will have been seen above, any true comparison between the figures published by the various joint-stock banks.

Here it may be stated that a "spot" operation in Foreign Exchange is the purchase or sale of foreign currency for delivery at once (*i.e.* "on the spot"). A "forward" operation is a purchase or sale of foreign currency for delivery at or within an agreed future time, the rate at which it is carried out being fixed at the time the arrangement is entered into. It is not proposed to enter at any length into the nature and volume of the "spot" and "forward" Foreign Exchange business of the banks; it must suffice to say ~~that~~ Forward Contracts in Foreign Exchange have been developed largely since the war, as a consequence of the varying value of currencies not resting on a gold basis; they provide a means by which both exporters

and importers can assure themselves against the fluctuations of Foreign Exchange. A bank is always prepared to sell or buy for its customers either "spot" exchange or "forward" exchange, covering itself by corresponding purchases or sales which may be "spot" or "forward" transactions, thus relieving itself of any risk in exchange rates.

There are other items of smaller importance affecting this line of the balance sheet—namely, Letters of Credit, Confirmed Credits, etc., etc.—to which conditions of space preclude further reference.

We now turn to the other side of the account. The first line is "Coin, Bank and Currency Notes, and Balances with the Bank of England." This represents the cash reserve which the banks hold in hand to meet the demands of their customers. It is reckoned as a percentage of the bank's liabilities to the public. The amount in the balance sheet before us, £34,647,000, is about 11·74% of the Current, Deposit and Other Accounts, though, as we have seen, it is a somewhat larger percentage of the portion of this last item which really represents liabilities to the public. The percentage is an average, as the banks have no uniform rule, and while

most of them only aim at keeping 10%, one of them publishes a ratio of about 15%.

The ratio is, in fact, purely arbitrary. It was fixed only when, after the war, the common form of monthly return was decided on. In the days before the war this item of cash was combined with the next, "Balances with and Cheques in course of Collection on other Banks in the United Kingdom." This item is almost, but not quite, cash. It is almost cash, because the bulk of it will, in fact, be turned into cash in the course of a day or two; but it is not quite cash, because it includes a certain number of cheques sent for collection which may be dishonoured, and also because cash with another bank in the United Kingdom is not in all cases quite the same thing as cash with the Bank of England. So in settling the common form of return it was considered better to keep the item of cash distinct. The percentage, whether 10% or 15%, was fixed upon, I believe, as the sort of thing that the public might fairly expect of the banks; it was a matter of self-respect that the banks should sacrifice so much of their profits.

It is, in fact, much more than is required for the ordinary working of a bank, and it is

fairly notorious that in practice it is by no means universally adhered to day by day. The floating balances of a bank are divided between the balance at the Bank of England and money at call on the discount market in a proportion which is continually varying, according to the calls made upon the till—calls which to a large extent cannot be foreseen. The balance of cash as shown in the monthly return is, by agreement, the average of the amounts shown in the weekly balance sheets of the respective banks. All that the managers of the banks have to do is to see that these weekly amounts average about the percentage of the current accounts and deposits at which the bank aims. So long as this average is kept up, the amounts from day to day of balance at the Bank of England and money at call in the market may fluctuate according to the requirements of the moment.

It will be seen that the banks make a large sacrifice of profit in thus keeping idle so large a cash reserve. In our composite balance sheet the sum of £34,647,000 would be worth at least 3% on an average, if employed in the usual channels, or one million a year, equal to a dividend of 8% on a total capital of something over £12,000,000. But at

least half of the cash balance is needed for the daily purposes of the till; the other half, say a dividend of 4% on their capital, is what the banks pay for the purpose of keeping up appearances.

It is commonly said that this line represents the banks' first line of defence in case of a crisis. This is only partially true. Reference to the Bank of England returns already set out will show what is the actual course of events in a crisis like that of July–August 1914; and it is hardly likely that a more severe one will be experienced for a long time to come. The increase in "Other Deposits" during those days of stress shows that the banks did not, in fact, draw upon their balances at the Bank of England; on the contrary, they increased them. And the increase, on the other side of the bank return, in "Other Securities," shows that it was by putting the market "into the bank" that they thus satisfied the demands of their customers while increasing their balances at the Bank of England. In other words, the first line of defence of the banks in that memorable crisis lay not in their cash balances but in their Money at Call and Short Notice, and to a large but unknown extent in the "run off"

of short bills, of only a few days' currency, which they held under the head of Bills Discounted.

As then this cash reserve is quite arbitrary in amount, and even to a certain extent fictitious—for it in no wise represents a minimum which is constantly maintained—it is hardly worth while to devote much attention to the curious fallacy which would make this percentage the basis of our whole banking system, as the foundation on which the whole power of the banks to "create credit" rests. It has already been sufficiently pointed out that the banks have, except to a limited amount by their acceptances, no power to create credit; they can only direct the use of credit which is created by quite another means. All that this percentage represents is a limitation of the power of the banks to give credit; evidently the more of their resources they lock up in reserves, the less is their power of lending. The fixed limit to the banks' power of lending is the amount of the resources placed at their disposal by depositors, together with so much of their capital and accumulated profits as is not fixed in business equipment, buildings and the like.

The creation of credit is, it must again be said, in the hands not of the joint-stock banks, but of the Bank of England acting as the agent of the Government. We have seen that the great creation of credit necessary in an acute crisis does not show itself either in the cash reserves of the joint-stock banks, which are slightly increased indeed, but to no great extent, or in their deposits, which remained about steady during the crucial weeks in July and August 1914. But the reserve of the Bank of England, and its proportion to liabilities, showed the full extent of the squeeze; the gold and notes in the Banking Department fell with great rapidity, while the increase in Other Securities showed the startling advance in loans. Since then the measure of the power of the joint-stock banks to lend, that is, the amount of their deposits, has been dependent on the Government requirements resulting in the expansion or contraction of credit, as controlled by the Treasury Note issue, by Ways and Means Advances, and by Treasury Bills; the banks have followed the expansion or contraction of their deposits thus brought about by contracting or expanding their cash reserves in proportion. But the amount of their re-

serves is not the cause, but the effect, of their ability to give credit.

On the next line, "Balances with and Cheques in course of Collection on other Banks in the United Kingdom" we have already touched, and there is little more to be said about it. The bulk of it consists of cheques which are on their way to the country, including Scotland and Ireland, and of which the vast majority will be collected and turned into cash in the course of at most three or four days. This item is what American bankers call "the float." It is, of course, much more important in the United States, where it takes four or five days to present in San Francisco a cheque forwarded from New York, than in the United Kingdom, where a cheque can be conveyed anywhere in twenty-four hours. It will be noted that cheques on banks abroad are not included here; of course they are not to be considered as equivalent to cash.

Before we leave these lines of the cash reserves, a word may be said on the mechanism by which the balance is controlled. We have seen that it is impossible to keep the balance really steady. The large clearing banks are the bankers not only of the large

country, Scottish, Irish and Overseas banks, but of the large financial houses of the City, including the great accepting houses, with whom we shall presently have to deal, and through whose hands no inconsiderable part of the floating money of the country passes. The balances which they keep with their London bankers vary very greatly; but they are subjected to heavy calls from their customers which cannot be foreseen, except within very wide limits. Their balances are held with the London banks at call, and though there is an honourable understanding that any large demands on them shall be advised beforehand as far as possible, yet the unexpected must needs continually happen. The manager who has the highly responsible task of "keeping the till" at the Head Office of his bank starts his day with an estimate of his probable receipts and outgoings for the day, and has to work to it in arranging in the morning the amounts which he can put out at call or short notice, or which he will have to call in in order to keep his balance right. But he is liable to many unexpected calls in the course of the day, some of which may even come from the branches of his own bank. Hence it happens that by the evening

he may find himself out in his estimates by as much as some millions, either in excess or default. If he is short, he has to rely on his balance at the Bank of England; if he is over, he has to bear the loss of interest on the balance till he can get it out. But there is a certain compensatory force at work. The bill brokers and the "money brokers" of the Stock Exchange are always on the look-out to find where money is available to complete their balance for the day; for of course it is not the bankers only who may find their estimates wrong. And at about the close of business hours there is a system of inquiry for "night money," lent to be repaid next morning. By this means a good deal is done to equalise the task of balancing up for the day. This money is, of course, lent at a very low rate; the banker will quote at times as low a rate for the night as 1% p. a., rather than make nothing at all on an excess of several millions.

Yet even so he must look to a very large fluctuation in his daily cash balance, represented, of course, mainly by his balance at the Bank of England. This he has to report daily to his Directors; if they notice any considerable excess or shortage in it, they will ask questions as to the condition of the

market, and thus watch the general tendencies on which their immediate policy must depend. But they have further to keep their eyes not only on the ease or tightness of the market for the day; the balance at the Bank of England for last night is a largely accidental amount. They have laid before them privately a weekly balance sheet, in which these daily variations are smoothed out, and the Bank of England balance must be then fixed as nearly as possible at such an amount as will give them the figure which they have fixed on as sufficient to provide, with till money and other cash assets in their possession, the proportion of cash to liabilities which they ought to hold. This weekly figure is further smoothed out in the monthly balance sheet which is issued to the public. Here the "Cash in hand and at the Bank of England" is the average of the weekly balances which have been before them privately.

It will then be understood that the monthly figure of Cash in hand and at the Bank of England is the average of balances which during the period may have varied very widely. In particular there will have been large variations between the two items of "Cash in hand" and "Money at call and

short notice." What the monthly balance does show is the fact that even where money has for a time been transferred from cash to short notice, it has always been in so readily available a form that it can be called in and returned to cash at least once a week.

Having thus set aside and sterilised the amount of cash which he looks on as the foundation of stability, the banker then has to consider how he is to employ that part of the money entrusted to him which he can safely lend out for longer or shorter periods. Evidently a considerable portion of it can only be lent for short periods in a manner which will assure rapid availability in case of need. It is impossible for a banker to foresee the calls which may be made upon him in the course of the next few days, and he must have some means by which he can supply his balance at the Bank in case of a sudden call upon his resources. This short money will to some extent represent the amounts which he holds upon time deposits running for various periods, from a few days up to two or three months. Of course he can feel confident that not all of these will be called in at once. Banking is after all on the whole a very steady business, and the variations in the amounts

receivable and payable, if taken in the gross, are only slight over short periods. But still a reservoir of short loans is very essential to cover all probable variations.

By "short money" the banker usually means loans running at periods of from one to fourteen days. The item stands in the balance sheet as "Money at Call and Short Notice." It consists chiefly of two parts—money lent to the bill-brokers at call or seven days' notice, and money lent on the Stock Exchange "for the settlement," that is, to enable brokers and jobbers to take up stock in the intervals between the fortnightly settlements.

The question of loans on the Stock Exchange can be dismissed very shortly. The settlements take place usually every fortnight, occasionally with an interval of three weeks. The uses to which these loans are put by the members of the Stock Exchange, and the mysteries of "contango" and the "carry-over" in general need not concern us here, the more so as an excellent account of the Stock Exchange and its mode of doing business has already appeared in another volume of this series. What concerns the banker is firstly the security he gets for the money he lends, and secondly its ready availability for repay-

ment at the settlement. In both respects Stock Exchange loans are of the highest class —the Stock Exchange is a close corporation keeping strict discipline over its members.

The only general exception to their ready realisation that has occurred, I think, within living memory was at the outbreak of the war, when the Stock Exchange was closed for a considerable period, and fortnightly settlements were not resumed till after the legal termination of the war. Stock Exchange loans were thus "frozen" like so many other loans, and by arrangement with the Government the bankers agreed to carry them till the legislature unlocked them.

With the manner in which the other part of the Money at Call and Short Notice is lent, and the general part which it plays in the banking system, we shall have to deal more at length when we come to the money market as a whole, and no more need be said here. So too with the very important item of Bills Discounted. But here we must pause for a moment to point out one ambiguity which occurs under this head. There is no distinction made between Treasury bills and commercial bills—between money lent on bills to finance the Government, and money advanced

to assist commerce. This is a matter on which a bank manager keeps a watchful eye, as affording a valuable indication of the course of commerce on the one hand, and of Government finance on the other. The two elements are entirely distinct, and there does not seem much reason why the information on which the bank manager sets so much store should not be communicated to the public. At present the only index of the course of trade afforded by the bank balance sheets is the item of Advances to Customers. Here, of course, it is possible to judge roughly how far trade is active by noting the demands for loans; but this information would be still more useful if the course of the import and export trades could be traced in the amount of bills on the market. As it is, this is entirely masked by the issues of Treasury bills, which depend on the needs of the Treasury and have at most a very indirect connection with commerce and industry. It must be confessed, therefore, that this item is not very informative. Not only does it make it impossible to see which way trade is moving; but it veils the amount which each bank holds of what is really a very important defence in time of need; for in real urgency a bank could always

realise its holding of Treasury bills by taking them to the Bank of England, which could not refuse to discount them if asked. That, however, is a remote contingency.

"Investments." It will be seen that the average under this head is just about 15% of the liabilities to the public. But the proportion varies considerably between the different banks, from 9·2% to 20%. The investments are almost entirely in Government stocks, with an infusion of other gilt-edged securities. At one time they were mostly in Consols or long-dated stocks; but since the war the number of Government issues of medium or short-dated securities has enormously increased, and a large part of the banks' investments have lately been in the form of National War Bonds, Treasury Bonds, and the like. As these near their maturity the Government has to induce the holders to convert into longer terms. Thus the tendency is for holdings in Conversion Loan and the like to take the place of medium-dated bonds.

This item is thus still under the influence of war finance. When the large war loans were issued, the banks agreed to subscribe large amounts, in a fixed ratio to their deposits,

and the proportion of investments thus swelled to quite abnormal figures. Some of the banks' subscriptions were made with an undertaking to the Chancellor of the Exchequer that they should not be sold till the market price had advanced to a considerable premium. Thus for a time investments were not only unduly swelled, but were unsaleable, and the banks took a risk which in ordinary times would have been considered quite beyond the limits of prudence. But the progress of inflation, by greatly increasing the deposits in the banks, reduced this undue proportion; and the rise in the price of Government stocks which followed the end of the war and rapid deflation made it easy for the banks to reduce their holdings at a good profit. Now the proportion is not very different from what it was before the war.

The investments of a bank are a very useful place for a moderate amount of loose funds. They give a fixed income, which tends to steady profits, and in ordinary times they are easily saleable. But they cannot be regarded as a safe resource in a crisis; in times of panic there are no buyers. At the end of July 1914 the Stock Exchange was actually closed, and all investments were absolutely "frozen."

Investments are therefore only a degree more liquid than Advances to Customers, and are treated by bankers as on a similar footing. When the demand for loans falls off, the banker puts his money into Government stocks, and when the demand for loans increases, he meets it in the first place by selling his investments.

This tendency was very marked in the six months from December 1924 to May 1925; the following figures will illustrate the movement. In December 1924 the aggregate deposits of the Clearing Banks (less National Bank) were £1,655,940,000. By May 1925 this had fallen to £1,597,965,000, a drop of about £58,000,000. During this period Advances had increased by about £37,000,000, from £811,214,000 to £848,638,000. In order to meet this increase the amount of investments had been reduced by about £29,000,000, from £303,199,000 to £274,363,000. Discounts had also been reduced from £234,400,000 to £200,096,000, indicating that Treasury bills had been allowed to run off in order to supply funds. Thus the increase of accommodation under the head of Advances had been obtained by reduction of advances to the Government under the two heads of

Treasury bills and permanent investments in Government stock.

But there is a danger latent in the employment of bank funds in long-dated gilt-edged securities which must not be forgotten. The capital value of such stocks varies with the general rate of interest on capital; and in time of depression when there is little demand for money, and rates fall, the market price of stocks rises. Such a period of stagnation occurred after the Baring crisis in 1890, when Consols, then bearing $2\frac{3}{4}\%$ interest, gradually rose to over 111 in 1896. The rise of prices of securities reflected the slackness of the demand for loans for industrial purposes, owing to the stagnation of trade, and the bank rate for a long time stood at its lowest level, 2%. Thus banking profits were difficult to earn, and there was a great temptation to banks to invest in securities whose capacity of appreciation seemed unlimited. But the demand for money created by the South African War, and the great increase in trade activity which followed it, sent the value of gilt-edged securities down with alarming rapidity. For several years up to 1914 banks had to provide large sums annually to write down their investments. More than one important

institution, of the Savings Bank class, whose Directors believed that in investing in Consols they were following a most conservative and prudent course, found themselves in difficulties, and in some cases liquidation, with all its consequent distress to the small investor, was inevitable. When the war was over, and confidence returned, while deflation was raising the value of all fixed investments, the price of gilt-edged stocks rose rapidly. The banks recovered the large sums they had put aside towards writing down their stocks, which had largely been converted, as we have seen, into shorter dated securities, where depreciation could not take place. These recoveries in value formed a most valuable addition to those hidden reserves against depreciation which render the banks to a great extent immune from such risks in future. But bankers have had a sharp lesson, which will not soon be forgotten; and it may be taken as certain that they will be shy of committing themselves to investment in any securities which are not protected either by a fixed and not too distant term for redemption, or by a very effective sinking fund.

The heading of "Advances to Customers and Other Accounts" is important enough to

be reserved to a separate chapter; and the "Liability of Customers for Acceptances, Endorsements, etc." we have already discussed on the other side of the balance sheet. With the remaining items we must deal in very summary fashion. The introduction into the assets of a separate heading to cover the investments of a bank in other banks which it controls by holding the majority or the whole of the shares is quite recent. The practice of thus holding other bank shares is, in fact, a product of the war, and of the fact that the amalgamations of the large banks had reached a point at which central control became difficult. So long as the operations of a bank were confined to England, where banking law and practice were uniform, it was possible to centralise the management in a head office in London. But when it was desired to extend the business of the bank to Scotland and Ireland, not only were the laws and the practice in many respects different, but there was a highly laudable national pride involved, and it was difficult to absorb and abolish an institution which had behind it an honourable name and high repute, in order to merge it in one whose name was half foreign and whose head office was far away

from any access by its customers. Thus it was that when the Scottish and Irish banks were in some cases drawn into the sphere of London banks, by the offer of an exchange of shares on terms so favourable that the existing shareholders could not wisely refuse them, policy suggested that the banks should continue to work under their old names and local management; their shares were held by the London bank, but kept alive, and their Directors were continued in office, working under such supervision as was deemed necessary, the London bank only holding in hand the power, in the last resort, to enforce their wishes by the right which shareholders have to dismiss Directors or officials whom they do not approve. In thus taking over the ultimate control of a large business, the holding bank does not indeed make itself liable to the depositors for their deposits. But it cannot be denied that there is a certain moral responsibility incurred by the holding bank. When the new form of monthly balance sheet was under discussion, it was felt that this consideration took such holdings out of the rank of ordinary investments held by the bank merely for the sake of the interest upon them; and it was very properly agreed that they

should be set out in a way which would show the amount and nature of the holding, and any uncalled liability on the shares. All creditors of the bank were thus fully advised of these outside commitments. It may be added that it seems only right that every shareholder of the bank should have proper knowledge of the position of these subordinate holdings by access to the balance sheet of each bank owned.

The first purchases of Irish banks took place during the war; the Scottish affiliations followed soon after. But the appeals which were publicly made to British banks to show more enterprise, and to take up the international banking which had once been mainly in the hands of the German banks, led to a considerable expansion of business on the Continent in 1919 and the following years. Some of the banks set up foreign branches of their own, others combined for the purpose; others held off from such outside ventures, and contented themselves with closer relations, short of purchase, with important Continental banks. Others purchased controlling interests on a large scale in various Colonial and Overseas banks. It is not possible at present to express an opinion on

the wisdom of this policy, which so far is only on its trial; but many important observers regard it not without apprehension.

The item of "Bank Premises" needs even less comment. They are, as has already been pointed out, an essential condition of existence for the bank, and must be regarded as a necessary investment of its capital. The business of all the large banks has grown with extreme rapidity since the war, and for them, as, for the community, the housing question has been acute. The large sums which stand in the various balance sheets of the banks represent only a part of what has been spent; for all the banks make a practice of writing down drastically the actual cost of the buildings. This is necessary because continual expansion makes necessary continual remodelling and rebuilding. Moreover, it is evident that no bank can expect to realise from an ordinary sale anything like the whole of what has been spent on such expensive provisions as strong-rooms and other special needs of a bank. And it may be added that a bank regards its premises as a most valuable advertisement Competition between the large banks is particularly keen in this direction; and the result is that the banks are

now not only the chief builders in the most important streets of every town and almost every village, but they are most anxious to do their best for the adornment of the towns, and the choice of architects and the approval of designs are matters of anxious consideration in every bank board-room. And it is not, I think, an exaggeration to say that the designs for new bank buildings are very nearly the most important part of the exhibits in the Architecture Room at Burlington House from year to year.

CHAPTER VI

ADVANCES TO CUSTOMERS

In the item of Advances to Customers we have reached what is the central portion of the activity of a bank. It is here that the banker is brought into direct relation with his customer in a manner which is essentially peculiar, and it is by the manner in which he lends the money entrusted to him that his capacity and usefulness to the community are judged. In receiving his money he is largely passive; he will open a credit account with no more than the assurance, by introduction or references, that his customer is a respectable person. But when he has to lend, he has to assure himself by inquiry, in every way in his power, that his loan will in the first place be repaid when due, and in the second that it will be used for legitimate purposes. It is here that all his faculties are called into requisition; his judgment must not be at fault, he must be cautious, but at the same time he must remember that he has to play an important part

in helping the commerce and industry of the country, and indeed of the whole world. And it is from his advances that the banker has to look for most of his profit; it is here that he has to meet the competition of his rivals in the most acute form. He has to temper liberality with caution; if he is too liberal he may easily impair his profits by bad debts, and if he is too timid he may fail to obtain an adequate return on the funds which are confided to him for use. It is by his capacity in lending that a bank manager is judged.

It is not quite exact to say that the line in the balance sheet of "Advances to Customers and other Accounts" is the measure of the assistance which a bank is giving to its customers. In the first place the "other accounts" are to a certain extent a matter of interior book-keeping. For instance, under this head come cheques on branches which are credited to customers before they have actually been debited to the account of the drawer in another branch of the bank. These form a variable but always small percentage of the "Advances, etc." item. On the other hand, a more considerable part of the assistance which a bank gives is classed under the head of "Bills Discounted." A bank is always

prepared to discount its own customers' bills, and in fact does so to a large amount. We shall see when we come to consider the Discount Market that one of the main heads under which bills may be classed, is that of customers' drafts on the firms, whether at home or abroad, to whom they have sold goods on credit on the understanding that the sale will be represented by an acceptance. The customers of the bank can either take these to a bill-broker and discount them on the market, or they can take them to their own banker, who is always ready to buy them for cash, provided, of course, that they are drawn on respectable firms and represent legitimate business transactions. If it is desired to know how far a bank is assisting the trade of its customers, this item must be kept in mind. The usual practice is to give each customer who applies a limit up to which his bills will be discounted, and to discount freely up to that limit; but, of course, to watch the bills, to see that they are drawn in the course of ordinary business for goods delivered to "approved" names, and to keep a careful eye upon any signs of "accommodation" bills or "cross-firing"—the name given to a practice which is occasionally adopted, where

two firms draw bills mutually upon one another and discount them, preferably at different banks, so as to keep between them a permanent loan, using the proceeds of one bill to pay off another when due and then renewing. A careful manager can always detect such a practice by keeping his eye upon the account, and will naturally take steps to put a stop to it when he has good reason to suspect it. This is, however, somewhat of a digression, merely designed to show that in discounting a customer's bills a manager is brought into direct contact with him, and has to guide himself by the conduct of the account, exactly as in the case of an ordinary advance; whereas, as we shall see, this particular relation does not exist in the case of bills which are discounted on the market. We may now return to the general aspect of the Advances to Customers.

Advances to customers are of the most varied nature, and cover the whole range of the commercial and industrial processes of the world. They may vary from loans running up into the millions needed by foreign and colonial Governments to the overdraft of a few shillings, or even pence, in the account of some hard-working and perhaps hard-pressed operative. The security may be of no less

varied nature—real estate, stocks and shares, commodities, personal guarantees, or the unsupported credit of the borrower. But one character they should all have in common; they should be running only for a limited time, with provision for reduction at least, if not full repayment, in periods to be measured by months rather than years. It is a cardinal point of sound English banking that there must be no "lock-up" of capital. A humorous banker is reported to have said that he would have on his books no "Kathleen Mavourneen" loans—"it may be for years and it may be for ever." The whole of the money entrusted to the bank by its depositors is withdrawable either on demand or at short notice; and the most evident prudence dictates that it should not be lent for a prolonged period. It is not the business of the banks to supply fixed capital to their customers; they cannot afford to do so, and where they have yielded to the temptation, the result has usually been disastrous. The prudent banker, when asked to grant a loan, will always inquire in the first place for what period the advance is required, and what is the prospect of its repayment by the expiration of the period. If he is not satisfied as to this, he must not let himself be

tempted either by the value of the security or the rate of interest offered; his chief thought must be for the liquidity of his advances.

It is a familiar fact that this limitation of the British banks, the practice adopted after many years of development, forms a marked difference between British and Continental, and more particularly German, banking. In Germany it was, before the war, the custom of the banks to use their resources freely in the financing of new enterprises. An industrialist of good standing, who had got hold of some promising new process or opening for extended trade, which required means beyond those at his disposal, could always bring it before his bank and ask its assistance. The banks had at their command staffs of skilled experts in the leading branches of industry, such as engineering, chemistry, textiles and so on. They would refer to them the proposals made, and if a favourable report were received, the bank would be prepared to take a "participation" in the new venture. A company would be formed in which the bank would take shares, often a controlling interest, and one or more of the Directors of the bank would take seats on the board of the new business. The

new process would be operated until it were proved successful. When the time came, an issue to the public would be made, and the bank would " unload," though often retaining a controlling interest in the company. In this way the banks held control of a large part of German industry, and were important factors in the creation of the great " Kartels " or trusts by which a small group of capitalists exercised an enormous influence over the industry and commerce not only of Germany but of the world. The German banks had very large Boards of Directors, who were told off to represent the bank on the various boards of companies in which the bank had a participation, and a system of " interlocking " directorates was thus formed which brought a great part of German industry under central control.

Now there can be no doubt that the German banks did in this way contribute largely to the development of German industry and commerce; and during the war it was a frequent complaint against English banks that they lacked the enterprise which would enable them to render the same services to British industry. But a little reflection will show that this criticism is ill-aimed.

The assistance which the German banks

gave was inevitably bound up with control; the banks would not risk their capital unless they were able to direct the application of it. Now it is clear that public opinion in England would not have tolerated the control of British industry by a few banks. Industry in Britain is based on individualism. Whether it may not be necessary to reconstruct it in the near future, if it is to hold its own, on the line of large combinations, such as the German Kartel or the American Trust, is a matter which may well be open to argument; but for the present Kartels and Trusts are objects of suspicion, and indeed in America are illegal. And it was as an essential step towards the formation of Kartels that the German banks assumed such wide control of industries. The English banks were not in a position to create such monopolistic associations, nor, had they been able, would public opinion have tolerated it. It is not merely a tradition of British banking, but a condition on which British trade has grown up, that the banks should act as auxiliaries, and not as controllers of industry. Indeed at the moment the tendency is to accuse the banking system of the country of an undue influence over industry. This is, of course, a direct contradiction of the accusation of want

of enterprise in assisting trade, and both are without foundation. The aim of the banks is to aid all branches of trade, the consumer and the merchant as well as the producer, with absolute impartiality. There might well be an outcry if they were to adopt a novel policy and were to embark their customers' funds in supporting, as owners, particular groups of traders in a competition with their rivals which might easily prove tyrannical. It might easily be said of the German banks that they are the arbiters of commerce in their own country; but it must be placed to the credit of British banks that they have, in spite of uninstructed public outcry, steadily refused to take upon themselves so grave a responsibility.

Furthermore, it is necessary to keep in mind that German banking is not founded, like English, on the current account and the cheque. The English banking system, as has been explained in the first chapter, is, in fact, further advanced and more highly specialised than the German. The German banks were undertaking functions which in London are divided between the deposit banks and the great merchant banking houses. They thus had to provide a very large capital, enough to cover the risks which they were carrying in their

industrial ventures as well as that which was the needed provision for the security of their depositors. But their deposits, especially those on current account, were far less in proportion than those of the English banks, because the use of the cheque was not so highly developed. Thus they could venture to risk a larger part of their capital in participation. In London the place of the banks in financing such outside risks is largely taken by the merchant bankers. The deposits which they take from the public are comparatively small; they are mostly private houses dealing with their own capital; and they are thus free from the responsibilities of trustees which weigh heavily on the Directors of the deposit banks. So it is that they are prepared to undertake such risks as the starting of new processes or the like which promise a return in profits adequate to cover the extra danger of loss. Outside the merchant bankers again there are in the City and elsewhere a not inconsiderable number of finance companies whose immediate object it is to undertake similar business. During the war the Government set up a Committee to inquire into the possibility of affording longer-term credits for the assistance of industry on the German plan.

The report of the Committee was unanimously to the effect that this was not business which the banks themselves could undertake. But it was agreed that an experiment should be tried, and a trading Corporation was formed with the express aim of giving such assistance. After several years of experience it can hardly be claimed that the operations of the Corporation have been so successful as to show that there was a real need for it. Nor, again, has the Government experiment in the same direction under the provisions of the Trade Facilities Act attracted business on such a scale as to show the existence of any great demand on the part of the industrial community. To all appearance the action of the joint-stock banks in confining their operations rigidly to the granting of short-term credits has not been any hindrance to British trade; the opportunities of financing offered by other bodies seem substantially to have provided all that was wanted.

The British banker then takes as his fundamental principle that his loans must be for a limited period only. As a rule he grants them for a period of six months and not more; at the end of that period they must come up for revision, and no renewal is promised.

The period is naturally dictated by the seasons of the year. Of some of the most important products on which the world depends it may roughly be said that it takes six months to harvest them and transport them to the markets where they are needed, and a second six months to distribute them to the ultimate users. The autumn season is the time when the raw materials have to be harvested and paid for, while the spring is the most active time for the retailer. Of course the seasonal alternation is less marked than it used to be, now that the southern hemisphere makes large contributions in great staples like wheat and wool. But it still remains true that there is a tendency for prices all over the world to rise in autumn and to fall in the spring; and it is in helping trade over these two periods that the banker has one of his most important functions. The six months' or seasonal loan may be said to constitute the backbone of his business. He smooths over the period in which the dealer has first to buy his stock and then to sell it and recover the proceeds from those to whom he has sold it. The merchant, in the most general sense of the word, must own sufficient capital to carry him on with a normal stock of goods, year in year out; but it is

perfectly legitimate business for him to seek from his banker help in carrying him over the fluctuations which always occur within the year.

Naturally the banker's customer does not always understand or accept this principle which guides the banker. So long as the banker is assured that his loan will be repaid within a certain short limit of time, he can afford to lend at a low rate of interest; and it is a common delusion on the part of customers that the banker should supply them with permanent capital in their business at the same low rate. Indeed some people have gone so far as to write books to show that the trader has a right to loans from his bankers on terms practically dictated by himself. But leaving these out of sight, there is always a certain tendency on the part of borrowers to get the better of the banker, and lure him into supplying them with permanent capital. For instance, a trader has built himself new premises, and comes to his banker for a loan, offering him as security a mortgage on his new property. The banker may be assured that the security is quite good for the amount asked; but he will tell his client that it is not the business of a bank to lend on mortgage,

he must not lock up his money in buildings. He will point out that there are well-known channels by which loans on mortgage can be obtained. There are always private investors who are prepared to lend through their solicitors or otherwise; and there are the Insurance Companies. As they have liabilities spread over many years ahead, the maturity of which they can calculate with great accuracy, they are always open to consider advances with a currency of several years, and a mortgage maturing at a date convenient for their future payments is very suitable for their purposes. The client will promise that he will at once take steps to secure a mortgage, but asks for a temporary loan till he can find the permanent money. The request is reasonable; but if the banker grants it, he will very likely find that no active steps are taken to get the mortgage; excuses are made, and the loan drags on without repayment. The fact simply is that the interest which the banker is charging on his temporary loan may be 1% or 1½% less than will have to be paid for a mortgage. A prudent manager, when asked for a temporary loan in anticipation of a permanent mortgage on buildings, will always assure himself that negotiations for the mortgage are genuinely

going on, and that both parties are more or less committed. Then, of course, he will lend with confidence.

A similar case which often arises is that of a company who come to their banker saying that they need more capital, and propose to make an issue of new shares or debentures. They ask for a temporary loan in anticipation of the issue, and then "are advised" from time to time that the moment is not suitable; and so, unless the manager is firm, the loan drags on till it becomes a part of their working capital. The general rule, of course, in such cases is that the money should not be lent at a lower rate of interest than that which they would have to pay in the open market for the new issue.

These, however, are only two specimens of the traps which beset the bank manager. The need of the rule is emphasised by many years of experience. It is to these "lock-ups" of capital that most of the troubles of the small country banks during the past century have been due. Local influences or local pride induced them in too many cases to lock up their resources in some neighbouring concern which was striving to advance more rapidly than its capital justified. The local

banker was induced to invest his own resources in aiding the overgrowth, which he had no proper means of controlling. When this had once been done, the catastrophe was generally only a question of time.

It is, of course, by its loans and advances that a bank is drawn into the closest connection with its customers, and has its chief influence over the course of commerce. All advances demand a strict inquiry into the security offered. When this is of an undoubted character and easily realisable, such as first-class Stock Exchange securities, the advance will in most cases be readily given, and the only point open to debate is the rate of interest to be charged and the date at which repayment is to be made. But in a large proportion of cases where the advance has to be made for commercial purposes against securities which are themselves involved in the business, the bank manager has to keep himself closely acquainted with the manner in which the business itself is being conducted. More especially is this true where advances are made without security, simply on the credit of the customer. There are, of course, many cases in which the mere name of the customer is as good a security as gilt-edged

stocks. But there are many cases—far more than is generally understood—where banks advance to a customer, on the security only of their knowledge of him and of his business. Very large sums of money are lent, for instance, to farmers solely on the security of a statement which they put in showing the extent of their holding, the stock upon the farm, their rents, and the nature and extent of their other obligations. The bank manager is expected to verify these statements as far as possible by personal inspection; but still more he has to rely upon his knowledge of the personal character of the borrower, his habits, reputation and capacity. It is by his ability to advise the central control on such points, and of course by the success of his advice as tested by experience, that a bank manager is judged. It is not enough that he should avoid bad debts; he must not be too nervous about making advances, and must remember that a bank has to be liberal in lending where loans are justifiable. A bank has to take its share of risks which are inseparable from all business enterprise. It is in the choice of risks to be taken that the ability of a bank manager shows itself.

It is commonly said that it is harder now

than it used to be in the old days of private banking for an enterprising and able young man to obtain from a banker that credit on the security of his character and capacity alone which will often give the start required for the foundation of a profitable business. For this complaint there is almost certainly no ground, and here I may perhaps refer to some remarks in connection with farmers' accounts which I made at the Annual General Meeting of the Westminster Bank in February 1923:

"We have had some figures taken out, and I confess they were something of a surprise to me. They refer, of course, to the loans we make for current business purposes. They show that of the total number of borrowers no less than 28% had their loans wholly unsecured, and a further 13% only gave partial security. In other words, 41% of the farmers who borrowed of us received credit on that personal knowledge by our managers of their character and business, which we are accused of totally ignoring. And I should like to add, to the honour of our managers and their judgment, that this is a class of business which we most willingly undertake, for it is one in which we make very small losses."

It is therefore pretty clear that, for the legitimate purposes of trade, credit on personal

character is given at least as frequently as it was in the days before the concentration of banking control in London. But other risks of the old country banking system have been eliminated. The country banker in old days was in too many cases subject to influence which made it difficult for him to make his advances on a purely business foundation. It was difficult for him to say "No" to the neighbouring landowner whom he used to meet on the hunting-field and at the county club, or the local mill-owner who was, very likely, an all-important supporter at a general election. It was difficult for him to refuse to "nurse" some important tradesman who was plainly drifting into bankruptcy, but whose failure would be a local disaster. It was very largely considerations of this sort which led the country banking system into the misfortunes which ultimately doomed it to extinction. The central control of branches at all events largely eliminates the element of local influence, and ensures an impartiality of treatment for all parts of the country. Hence no doubt the complaints of those who would have been unduly favoured under the old system.

It may be said, however, that there is one broad distinction between the loans which a

banker is asked to make—the distinction between "speculative" and "legitimate" advances; and it is supposed to follow that the banker is bound to discriminate against speculative advances. There is considerable truth in this; it is a distinction which the banker must always keep in mind, but which it is not always easy for him to observe.

The fact is that the distinction between "speculative" and "legitimate" resembles closely that between "firm" and "obstinate"; it is a question of the angle at which the observer is observing. The real distinction is between "speculation" and "enterprise," and the line between them must be differently drawn under different circumstances. The impulse to extend business boldly, to take risks, is the impulse under which all advance has been made; it is the mainspring through which trade recovers from a period of stagnation and sets off on the upward curve of the "trade cycle." In the course of the upward curve a point is reached at which "enterprise" becomes "speculation" and prices have reached a height which cannot be maintained. The banker has to do his best to mark this point, and before reaching it to put on the brake, in the interests of his clients as

well as his own. This function he will endeavour, to the best of his ability, to fulfil; but it is a difficult and trying task, and it is, moreover, one in which he can only play a secondary part. It is after all the specialists in the various branches of industry and commerce who have the most intimate means of forecasting the future for themselves. The only advantage the banker possesses is that he is in touch with many different branches, and can collate the information he is thus able to collect. But he must act chiefly by advice; instructions must be given from the central control to all branch managers to scan carefully all applications for fresh advances, and to put forward for sanction only those that are for legitimate trade purposes and have no element of speculation in them. But this action is slow; if anything drastic is needed, it is only the supreme authorities, the Treasury and the Bank of England, who can act immediately and effectively. It is perhaps permissible to say, with due discretion, that the great restriction of credit and fall in prices which took place in 1920–2 was brought about in this manner. The banks were approached and received an intimation that the Government had adopted a policy of deflation, and

the banks were invited to support it by curtailing their credit facilities. The banks gave the authorities to understand that they were fully aware of the position, and were doing their best to stop speculation by a rigorous investigation of all new applications for credit; but that it was not in their power suddenly to cancel advances which had been already made for specific periods, nor did they consider themselves justified in refusing credits which appeared to them to be necessary for the maintenance of trade. The rate of interest which they charged for advances was, with hardly an exception, fixed in relation to bank rate; they could not suddenly raise the rate themselves, though the Bank of England could always oblige them to do so. There was, in fact, little that they could do. The Government, however, took the matter in hand. They deflated rapidly by very large repayments of public debt, involving reduction in the outstanding issues of Treasury notes and in the floating debt generally, and the Bank of England on April 15, 1920, raised its rate of discount to 7%. The effect was immediate, prices dropped, everyone rushed to realise assets, the value of securities pledged to the banks fell. But the effect on bank advances

was much more gradual. It was not till 1922 that the full effect of the Government policy showed itself here. In that year the total advances, discounts, acceptances and endorsements of the banks had fallen by £140,000,000. The banks had to put forth every effort to relieve the strain upon their customers, and the amount of "frozen credits" which they were carrying became a matter of common talk. And yet, such was the irony of the situation, the banks were at the same time accused publicly of having brought about the slump by a violent curtailment of credit. The whole story is an apt illustration of the fundamental theme that alike the creation and restriction of credit generally are in the hands of the Government, in other words, of the Treasury and the Bank of England acting as a Bank of Issue. The deflation of the currency was assisted by the large Budget surpluses of the years 1920–1, 1921–2, and 1922–3. By means of these surpluses, together with the provisions for debt redemption contained within the Budgets, the floating debt was reduced by over £453,500,000. This reduction showed itself in the large ultimate reduction of the deposits with the banks, and this in turn involved a corresponding decrease in the power

of the banks to give advances. The banks were but the last link in the chain by which the effects of the Government policy were brought to the banking accounts of the traders. It was perhaps not unnatural for the traders to fancy that the banks were the cause of the inconveniences from which they suffered. It will, of course, be understood that no criticism of the action of the Government is implied in what has been said. The policy of deflation was wholesome, though painful, and was carried out with courage and wisdom. But it was the policy of the Government, and the banks must neither be praised nor blamed for it.

The control thus exercised over the power of the banks to restrict or extend their loans, though it depends ultimately upon the restriction or extension of the currency, is exercised directly through the power of the Bank of England to raise or lower its rate of discount. The Bank of England holds the ultimate reserves of all the other banks; it is to the Bank of England that they have to look in times of stress. And the rate which the Bank imposes for a supply of currency controls the rate which the other banks have to obtain from their customers. Hence it is that the

rate for bank loans is, with very few exceptions, based upon bank rate. The most usual rate for loans which may be regarded as fair banking risks, the average rate, in fact, for advances on what may be called average security, is generally " one per cent. over bank rate varying."

In addition to the rate for the loan, the banks almost always protect themselves by charging a minimum below which bank rate will not be followed. Naturally the " overhead " charges which the banks have to meet are very heavy indeed; and the minimum which they charge is such as to make sure that these are covered. When the bank rate falls very low the banks can in any case make little or nothing out of the money which they lend " on the market," and the whole of their profits have to come from loans to customers. It is therefore necessary to fix such a minimum. It may be said that in normal times the rate which the banker looks on as his ideal is " one per cent. over bank rate varying, with a minimum rate of five per cent.," or, as it is generally expressed, " one over minimum five." But here comes in the question of competition between the banks. Though there is a general understanding between banks that

they will not openly "tout" for accounts of other banks, there is nothing to prevent private inquiries by customers themselves, and, in fact, the banks are kept well in order by this facility, and a bank which attempted to charge rates which were unduly high would soon find itself losing accounts to its competitors. The rates for loans are, in fact, settled by the "haggling of the market," and of a very open market. The same is the case with the rates allowed for deposits. But both are fundamentally controlled by the currency policy of the Government. It cannot be too clearly understood that there is nothing of the nature of a "Money Trust" between the banks; it is impossible that there should be one while the central control is so completely nationalised. The only "Money Trust" at the present time is that which is controlled through the Treasury by the Chancellor of the Exchequer.

The control of Government is, however, extended into some regions which might be thought to be a part of the internal economy of the bank. This is the case, for instance, with loans to public bodies, particularly municipal authorities. All municipal loans are entirely controlled by the Ministry of Health, in

succession to the older Local Government Board. The Ministry inquires into all the circumstances of the loan, the manner in which it is to be employed, and the period within which it is to be repaid. The bank which keeps the account of the municipal authority is not in any way consulted; notice is given that the loan is to receive the sanction of the Ministry, and when that sanction comes, the bank has no choice but to make the advance or to see the account transferred to another bank. The terms of the loan, as regards interest, remain to be settled with the bank, subject always to the possibility of competition. The bank has, of course, no Government guarantee, but to all intents and purposes it acts as a Government department, as much as if it had been actually nationalised. It is the competition between the banks which has produced the effect of placing public bodies in the position of favoured customers; the possession of the accounts of the Councils is eagerly competed for between the banks, even at rates which are not remunerative. For to be the banker of the Council is regarded as the best possible local advertisement, and one for which the bank is prepared to make some sacrifice. It is not at all impossible that,

if the banks were to be actually nationalised so that a Government monopoly was created, the result might be, curiously enough, that public bodies would receive not more, but less favoured treatment than they do at present.

CHAPTER VII

THE ACCEPTING HOUSES

We now pass on to a very important member of the English banking system—the Merchant Bankers or Accepting Houses. They represent a highly specialised development of the financial structure which has grown up, side by side with specialised deposit banking, in the course of the last century. They are almost without exception of foreign origin, but during the century or more through which they have been established in London they have become thoroughly Anglicised. While the great private banking families of London were in the first half of the nineteenth century building up the system of deposit banking, similar banking families on the Continent were gradually being drawn to London by the attraction of the great overseas trade which had been founded, with the growth of the factory system, by English enterprise during the Napoleonic wars. Napoleon's "Continental System" had forced Britain, and her

naval supremacy had enabled her, to win control of all international trade.

During the whole of the seventeenth century it was Holland which held command of the Eastern and Colonial trade. Amsterdam was the entrepôt where the goods of the Indies were warehoused and distributed all over the Continent. Holding the position of a distributing centre, Amsterdam naturally became also the centre of finance for international trade. The Bank of Amsterdam was established in order to set on foot what was practically an international currency. Against deposit of good coins of any currency it was prepared to open accounts in bank money, charging for its services and undertaking to hold in its vaults all the coin deposited with it. It had no power to lend money or discount bills. But all bills in which Amsterdam dealt must be made payable in bank money; and at the same time the receipts of the bank obtained currency, and passed freely from hand to hand. The discounting of bills was in the hands of a certain number of privileged bill brokers, who were the first example of the discount market as distinct from the actual banks.

For nearly two centuries—the Bank of

Amsterdam was founded in 1609—Amsterdam remained the great centre of international finance. The money of the Bank of Amsterdam was so convenient for the purposes of international exchanges that bills were drawn on Amsterdam for facility of negotiation, even though the actual goods were not themselves sent for storage in the warehouses of the city. The reputation of the bank stood so high that its receipt for money deposited with it was actually more valued than the coin itself which the receipt represented; for it could be transferred from hand to hand, while the coin deposited, the coin of almost every nation in the world of commerce, was variable in standard, worn, and in any case needed a guarantee of its intrinsic value. This guarantee was given by the receipt of the bank, which could be transferred without the expenses of assay and the like which would be needed if the actual coin were to be given in payment.

But bad times came. During the wars at the end of the eighteenth century Holland was drawn into the flood of Napoleon's enterprise; she had to be at war with England, and her great colonial empire fell into British hands. Her overseas commerce was cut off,

and the warehouses of Amsterdam were drained of the goods against which the bills of her international trade were drawn. Worse than this, it was found that the affairs of the Bank of Amsterdam had been illegally mismanaged. The bank was a State bank, established by the city of Amsterdam, and managed entirely by a Committee of the Town Council. As is always likely to occur where a bank—or other business—is in the hands of those who have been elected to their posts for political reasons, it came out that a succession of dishonest burgomasters had, against the strict rules of the bank's constitution, been lending out the money which should have been held in the vaults as cover for the receipts issued against it. The money had been lent for political purposes—some of it for a municipal money-lending scheme, designed to help the unemployment caused by the war, some of it to the Dutch East Indian Company, which carried great political influence. The revelations shook the credit of the bank to such an extent that about the end of the war period it had to wind up its affairs.

Thus it was that several of the great merchant banking houses of the Continent found it worth their while to transfer their

international offices to London, which they foresaw was destined to supplant Amsterdam as the pivot of international finance, even before the time when Waterloo once more threw the commerce of the world open to all. The London house of Rothschilds had been opened for some years before they confirmed their position in the City by early information of the result of the battle of Waterloo. The name of Baring had long been familiar, and as early as 1770 Sir Francis Baring, himself of foreign extraction, had founded the house and the family destined to play a brilliant part in the statesmanship as well as the finance of the British Empire. The house he established was in alliance, through the family of Labouchere, with the Hopes of Amsterdam, an English house which had taken a leading part in the banking circles of Holland. Another name which came to London from Frankfort at the very beginning of the century, and like the Barings was destined to rise to political distinction, was that of Goschen. Somewhat later the Schröders of Hamburg established a house of the first importance in London, while the Hambros brought to London an extensive connection with Scandinavian finance. Other important houses were

of American origin, and kept up a close connection with their allied houses in the United States.

It is remarkable that, while all the large private deposit bankers of London who rose to importance during the last century have now been absorbed, with one or two exceptions, into the stream of joint-stock banking, the names already mentioned, with a few more, still constitute the aristocracy of the City of London. The name of Merchant Bankers is more accurately descriptive of their work than the title, now usual, of Acceptance Houses. One of them has quite recently amalgamated with a bank doing similar business, and now frankly calls itself Hambros Bank. But they are differentiated from banks proper, in the modern English sense of the word, because they do not do deposit banking, or hold themselves out as taking money on deposit withdrawable on demand by cheque. They do, moreover, at least some of them, import and export goods on their own account. For these reasons they do not claim to be bankers, and do not join the British Bankers' Association, preferring to maintain an organisation of their own, the Accepting Houses' Committee. But they work in fairly close

alliance with the banks. In particular, their partners frequently sit upon the boards of the joint-stock banks, and of the Bank of England, where their special knowledge of important branches of financial operations gives them a very great influence.

It may be well to give here a brief account of the machinery by which the payment of goods exported from one country to another is carried on. When an exporter puts his goods on board a ship, he receives a bill of lading, which acknowledges the receipt of the goods. This usually has to be accompanied by a policy of insurance on the goods, and an invoice showing their price and total amount, and, according to the uses of some countries, various consular and other certificates for use in the Customs House through which they will have to pass. These are known as the "documents," and the possession of them gives the holder the right to obtain the goods from the ship when discharged and to deal with them as his own.

The terms on which the goods are sold vary, of course, for many reasons. It may be that they are sold for cash on delivery. In this case the exporter draws a sight draft on the purchaser, and hands it, with the documents

attached, to his banker. The banker forwards the draft and documents to his correspondent in the place where the purchaser resides. The correspondent advises the purchaser that he has the documents and will hand them over on payment of the draft. If all is in order, the draft is paid, the documents are given up, and the proceeds of the draft are remitted by the correspondent to the exporter's banker, who credits his customer with the amount, and the whole transaction is closed so far as the exporter is concerned.

But it is highly probable that the purchaser may not have been prepared to buy for cash on receipt of the goods; he may have required credit, in order to enable him to dispose of the goods and collect the proceeds in time to enable him to meet his draft. In that case the exporter will draw a bill on him not at sight, but for the period of credit agreed on, a period which is commonly fixed by the custom of the particular market in which the deal takes place. The most usual terms are sixty days or ninety days' "sight," that is, dating from the time when the bill is presented for acceptance. The exporter will now attach the documents to the bill and forward it through his banker to be presented for acceptance.

He will have further to give instructions whether the documents are to be given up to the customer on acceptance or not. If they are given up, the customer obtains them, and for the currency of the draft the seller is dependent solely upon the credit of the purchaser, for which he has no longer any security in the form of a right to the goods. He may therefore stipulate that the documents are to be held by the correspondent of his banker on his behalf till the draft is paid, in which case he is secured by the power of taking possession of the goods in case of default by the purchaser. In this case the drawee has the option of retiring his acceptance under rebate of interest any time before maturity so that he can sell his goods in block or by instalments as may suit his convenience or circumstances compel. Otherwise he must arrange with the holder of the bill to have the relative goods warehoused on arrival, and the bank in the absence of definite instructions to the contrary will insist on retaining control. When the bill has been taken up the bank will instruct the warehouseman to release the goods or make the necessary delivery.

This, however, is not a very convenient arrangement for the purchaser, who naturally

wishes to have his goods at his own disposal as soon as they are landed, and will be inclined to stipulate in his contract that the documents shall be given up to him as soon as he has accepted the bill drawn upon him, and undertaken thereby to pay at a given date. In this case the seller of the goods has no further lien upon them; he has only the promise to pay. He is thus in a less favourable position than if he were holding the goods in his own possession with power to sell them if the bill is not paid. But in either case he is giving credit to a debtor in a foreign country; and the risks he is thereby running are very considerable. When he gives credit in his own country, his debtor is more or less under his eye; at all events he is in a much better position for watching him and forming an opinion as to his position. And if anything goes wrong abroad, he has to depend for the necessary steps upon those who are acquainted with the laws of the country where his debtor is. If, for instance, there is any dispute about the goods he has sold, he may have to sue in a foreign court; and if he still has them under his control, he may have to sell them under conditions of which he is ignorant. A merchant who sells to many foreign countries

must, if he is to give credit safely, either confine himself to purchasers of whom he has intimate knowledge and whom he can absolutely trust, or else set up a machinery for watching his debtors in every country to which he sells. Giving credit abroad can therefore be a risky, and even an expensive, proceeding.

Hence the necessity for a class of experts who specialise in foreign credits. They make it their business to have representatives abroad whose function is to know all about the principal importers and exporters of their country, and to watch every change in the financial conditions around them. This is the function which was taken up by the Accepting Houses, and of which they had for long almost a monopoly. They had, as we have seen, in many cases old family connections with Continental countries, and for a century or more they were engaged in extending their connections. They possess to-day the experience and the accumulated information of several generations who have been engaged in the same business. And they are thus prepared to offer their services to the exporters and importers of all countries. They relieve the exporter from his risk by giving the assistance which the importer needs. The

exporter draws his bill not on the customer who buys his goods, but on the house which undertakes to accept on behalf of the purchaser. The standing of the chief Accepting Houses is such that their undertaking to pay over the amount by a given date enables the exporter to sell his bill at any time at a fine rate of discount, thus reaping the benefit of the difference between the buying rate for gilt-edged paper and an ordinary trade bill, the acceptor of which may perhaps be but little known and whose name may not command unquestioned credit in the exporter's market.

The method of procedure under this system will then be as follows: The exporter, in making his contract of sale with the purchaser, *i.e.* the importer, will stipulate that payment is to be made by means of a credit to be opened in his favour by a house of high standing. Evidence that the credit is actually arranged must be supplied by the furnishing of a Letter of Credit or otherwise. The exporter will also, if he is in a position to do so, stipulate that the credit is to be "confirmed," *i.e.* irrevocable. If this is not done, and the exporter has to rely only on an "unconfirmed" credit, he may find, after he has shipped the goods

and forwarded the documents, that acceptance is refused, on the ground that the credit has been cancelled. It may have been cancelled by the importer, who for some reason or other may wish to get out of his bargain, or even possibly by the Accepting House itself, who may have good reason for withdrawing the credit, although such a contingency is rather remote. The confirmed credit, however, is the only one on which the exporter can absolutely rely for payment; this, once granted, cannot be modified or cancelled without his consent.

Before granting the credit the Accepting House will, as a rule, stipulate for some sort of security. They may, for instance, insist that they hold the documents until the relative acceptance has been fully provided for. On the other hand, they may agree to surrender them at once against other collateral, the extent of which will be dependent on the standing of the importer. In the former instance, retirement under rebate will always be permitted, and this facility is not infrequently availed of upon arrival of the goods. An undertaking to place the Accepting House in funds at least three days before the maturity of any bill that they may be called upon to

accept is also often required. Thus so long as the importer remains solvent they are never actually out of funds; what they have done is to guarantee that the purchaser will pay a sum of money at the expiration of the agreed term; and on the strength of this guarantee the drawer is able to obtain his money at once. He can go to his banker, exhibit the Letter of Credit which authorises him to draw his bill, and his banker will thereupon buy it from him for cash down, less, of course, an amount for interest during its currency and for any expenses which may be incurred in collecting it. His banker will proceed to forward the bill to his London correspondent, who has to obtain acceptance of it, and who will then hold it till maturity or re-discount it as may suit his convenience. When the bill has once been created and bought by a banker, it becomes a negotiable instrument which can be transferred from hand to hand by endorsement, each endorser undertaking the liability for repayment to the person to whom he passes it on; and thus the bill may be used for remittance from one financial centre to another, till it is at last presented for payment to the acceptor at the due date.

It is by the circulation of bills of this nature

that all international payments, whether for goods or services, are in normal times carried out. A very large amount, in the aggregate probably some hundreds of millions of pounds sterling, is always afloat in bills drawn on London. There are in addition bills drawn on other financial and commercial centres; but none of them approach London in amount. Since the war the Americans have done something to make a rival centre of New York; but the plant of custom is one of slow growth. The acceptance of bills was for long forbidden to American banks, and it is only recently that the custom has grown up of accepting dollar bills and employing them for international payments—chiefly for settlement between the American countries other than the United States, and New York. Some progress was made in the replacement of the £ by the $ while the £ was at a discount in the exchange; but since the resumption of the gold standard in London a check has been put upon the process.

This is a rough outline of the practice of the Accepting Houses with regard to their commercial clients in foreign countries. It will be seen that it implies an accumulated fund of experience and tact such as explains well

enough the fact that the chief part of the business should be concentrated in the hands of comparatively few firms of large resources, old-standing foreign connections, and an unbroken tradition of sagacity and integrity. It is easy to see why it comes about that the Americans, keen men of business though they are, have found so much difficulty in making New York an accepting centre to rival London.

But this is not the whole of the accepting business which is done in London. There are abroad many quite good firms who do not enjoy what may be called an international credit; they are not of the high standing which would tempt the London Accepting Houses to do business with them direct. But they are known to their own banker abroad; and when they require a credit established, it is very usual for them to go to their own bankers, and ask that a credit may be opened in London for their account The foreign bank, being satisfied as to their customers' position, will thereupon write to its London bankers, and arrange for the opening of a "third party" credit for account of their clients, and the London bank, being satisfied as to the position of the foreign bank, will advise the credit on the strength of their customers' standing and

on the account they maintain. Most of the chief foreign banks have, in fact, important credits running which are chiefly, and often solely, operated upon in this manner. This, of course, is not quite so cheap to the foreign bank's client, who has to pay a double commission, but the best of the foreign banks, particularly perhaps the American, do business on so large a scale and are of such undoubted standing that the competition between the London banks for their accounts is very keen, and very low rates are quoted to them for acceptance facilities; so that in some cases it happens that the ultimate charge for the credit is not more on this plan than in direct transactions between the foreign merchant and an Accepting House.

The accepting business has been much more in the hands of the banks since the war than it was before. When war broke out, the first result of it was to make illegal the collection of debts from an enemy. The Accepting Houses all had large sums coming due to them from the Continent, particularly from Germany, to provide for running acceptances up to three and sometimes six months. These sums they were forbidden to receive, though their foreign debtors were willing and able to

pay. It was very rightly felt that as the State forbade collection, the State ought to step in and protect the credit of the Accepting Houses. One of the first steps of the Government, therefore, was to provide that the acceptances of these houses, as they came due, should be taken up by the Bank of England, and, in the phrase of the day, "put into cold storage." This very wise step enabled the Accepting Houses to carry on their business; but it was naturally much crippled, and it became the practice for foreign banks to call for the acceptance of an English joint-stock bank before they would buy bills on London. At the same time there was a tendency to restrict the term of credit, and the ninety days period was largely abandoned in favour of the "sight credit." This was the natural outcome of inflation, which made all merchants and manufacturers flush of money; bank balances were greatly increased, and it was more profitable to pay cash than to pay the interest on a credit. Thus it became a common practice to forward documents attached to a draft at sight, to be handed over to the importer of the goods as soon as the draft was paid.

The war has also had another notable result. Up to 1914 the large German banks

had offices in London which they employed largely for the purpose of giving their acceptances a London domicile, enabling them to be freely discounted on the London market—a striking evidence of the predominance of London. They brought to London and held there large balances which they employed on the market, as a reserve against their liabilities here, and their position was a very strong one. At the outbreak of the war they were, of course, placed under a sequestrator and their London business was liquidated; in the case of the best of them their liabilities were fully discharged. But their active business had been brought to an end, and it was not till the new treaty with Germany in the beginning of 1925 that they were given power to reopen in London. Of that permission they do not seem to be in a hurry to avail themselves; and in the present shortness of capital in Germany it is evident that they can use their resources more profitably at home than in England. The result is that the financing of German foreign trade has, at least for the present, passed chiefly to those of the great Accepting Houses who have always had special connections with Germany; and it may be conjectured that they are at present

in a stronger position in international trade than they have ever been.

One or two of the large French banks, and some American banks, also have London offices in which they do a banking business in competition with the London banks and Merchant Bankers. Their presence, however, is not resented. The bankers of London generally take the view that the presence of foreign bankers tends only to bring business and to emphasise the supremacy of London in finance; the bigger the market, they hold, the more profit is there to be made. When foreign bankers are once established in London, it is less likely that they will allow their financing to be decoyed away to other centres.

The Merchant Bankers of London also fulfil another function of the highest importance They are the financial advisers of most foreign Governments, and issue their loans here. Naturally when loans are brought out under the auspices of our own Government, such as the recent loans sanctioned by the League of Nations to Austria and Hungary, or, under the Dawes Commission, to Germany, the Bank of England takes the lead. But almost all the other foreign loans issued in London have been brought out either by

Merchant Bankers themselves, or by syndicates, in the case of large issues, of which they have formed a part.' With these may be included also a very important series of municipal loans for the chief cities of the Continent. In virtue of this power of issue the Merchant Bankers of London have had an excellent influence in keeping some of the lesser powers of the world in the path of financial honesty.

It may be further added that the business of the Merchant Bankers is foreign business in the strict sense; it has never extended much in the confines of the British Empire. Here the financing of exports and imports is carried on by the Overseas and Colonial banks. The financing of trade to and from India and China is in the hands of a few large banks which are commonly known as the "Exchange banks" par excellence. Some of them have their Head Office in London, others in India or China. But all are firmly established alike in London and in the chief seats of their activities across the seas. They have grown up with the business which they have to finance. The large merchants, like the banks, are strongly represented on both sides of the water; the fact that on both sides they share

a common nationality has rendered unnecessary the services of a middleman such as are needed outside the limits of the Empire. The Exchange banks are always ready to buy good commercial bills at the finest market rates; they know intimately the character of the firms with whom they are dealing, whether in India or at home. The bills which they buy in India or China are practically all on London; they are sent home and re-discounted freely on the London market.

CHAPTER VIII

THE DISCOUNT MARKET

A LARGE part of the world's overseas trade is financed, as we have seen, by bills drawn upon London, that is, either on London banks or Accepting Houses, or on the London offices of foreign or English overseas banks. These all have to come to London for acceptance, and when accepted usually stay there till they are due to be presented for payment. This represents a large amount of capital locked up during the currency of the bills. The owners of the bills generally can find a good use for this capital elsewhere, if they can borrow it at reasonable rates on the security of the bills. On the other hand, the banks and great financial houses of London are usually the depositaries of large amounts of floating capital for which they are anxious to find an employment by lending on securities for a short period.

There is no class of security for an advance which suits the banks better for temporary

employment of their funds than the commercial bill. It has a definite period to run, and can therefore be bought so as to suit the convenience of the banker to meet at its maturity the obligations which he can foresee as falling due at definite future dates. In addition to this advantage, the large majority of bills created in foreign trade are, under normal circumstances, as they appear on the London market, above suspicion where the solvency of those who are responsible for their liquidation is concerned. They may be drawn upon one of the Accepting Houses, or upon a large London joint-stock bank, where the signature of the acceptor is sufficient guarantee; or they may be drawn indeed upon an acceptor of less standing or at least on a name less generally known, but they come with the endorsement of one of the large Exchange Banks, who have bought them in the market in the East and forwarded them for discount to their London office. All these come under the general designation of "Bank Bills," and command, in virtue of their unsurpassed credit, the very finest rates of discount current at the time. In addition to these, there are always afloat on the market, since the beginning of the war, large amounts of Treasury

bills, issued by the Government from time to time, and tendered for by the banks and discount houses. Some of them indeed are taken by private firms as a temporary reserve for superfluous cash; but the gross amount thus held is comparatively small, and the fact that they are not issued in smaller denominations than £5,000 makes them hardly available for the small investor. Thus they do not seriously compete with the deposit accounts which the banks open for their customers, though the rates at which they change hands are somewhat higher than those allowed by the banks for deposit accounts.

It is the large amount of these floating Treasury bills which explains the chief alteration in the aspect of the discount market brought about by the war. It is largely by the issue or withdrawal of its Treasury bills that the Government controls the market, and carries out its policy of inflation or deflation. During the period of inflation the amount of this floating debt grew by leaps and bounds. In the earlier stages of the process the banks used to wonder whether the market was not being flooded with Treasury bills beyond its power of absorption. But it soon became apparent that the money thus

borrowed was only a creation of credit; the sums borrowed were at once disbursed to the public, and came back to the banks in the form of additions to their customers' deposits, and so the circle went on continually expanding. The amount of Treasury bills running grew as follows during the period of inflation :

		£
December	1914	99,000,000
	1915	380,000,000
	1916	1,116,000,000
	1917	1,058,000,000
	1918	1,095,000,000
	1919	1,107,000,000

The process of deflation began in 1920 and proceeded thus :

		£
December	1920	1,102,000,000
	1921	1,060,000,000
	1922	719,000,000
	1923	652,000,000
	1924	626,000,000
	1925	635,000,000
March 31,	1926	565,000,000

It will be seen that the amount of bills outstanding has now remained almost steady for four years.

It is to the tenders for Treasury bills that one looks as the best index of the state of the market from time to time, the relation, that is, between the money which is seeking temporary employment and the openings for using it in the discount of bills. When the supply of disposable capital falls short of the demand, the price offered for Treasury bills falls, that is, the rate of interest at which they are discounted rises. The tenders are made at rates minutely discriminated. For instance, on 9th April, 1926, Treasury bills to the amount of £40,000,000 were offered for tender. Tenders at £98 18*s.* 1*d.* or above received allotment in full, and the average rate worked out at £4 7*s.* 6·01*d.* per cent.—a rise of 4·03*d.* as compared with the figures for the previous week.

The tenders for Treasury bills form the machinery by which the Government policy of inflation or deflation now controls the market. The Government offers certain amounts for tender; these amounts may or may not exceed the total of bills which are maturing at the same time. If a smaller amount is offered than is running off, the Government are diminishing the total amount of bills on the market; that is, they are paying

off so much of the floating debt and to this extent deflating. The policy of the Governor of the Bank of England in raising or lowering his rate is primarily governed, under existing conditions, by the necessity of protecting his stock of gold, that is, by the rate of the foreign exchanges. But at the same time he has to keep his eye on the ruling rate of discount for Treasury bills; for this shows him whether his rate is "effective." If the rate for bills is much below the bank rate it shows that he has lost command of the market, and has to face the possibility that those who are lending in the market may not be content with the rates they are getting for their money, and, if they are foreign lenders, as, for instance, the American banks, may withdraw what they have placed in English bills and transfer their balances for investment in New York rather than in London. Thus his bank rate may not be able to control his gold reserve; for the transference of balances from London to New York means that the American exchange goes against London; in other words, dollars are in demand and sterling is being offered for sale, so that sterling depreciates in terms of dollars. And as the exchange falls it tends to encourage the transfer in actual gold.

The means which the Bank of England can take to make its rate effective are somewhat of a mystery; they are indeed commonly known in the market as the "hidden hand." The method consists, of course, in the selling or buying of securities, according as it is wished to take cash off the market, or to put more cash on it. In old days the usual process was what was called "lending and borrowing on Consols." Consols were before the war so large a stock that quite large dealings in them, whether for cash or "for the account," could be effected without calling the attention of the public. When the Bank wished to "borrow on Consols," thus taking cash off the market, the practice was to sell Consols for cash, which was always possible, and to buy them back in advance for the next settlement, which might be as much as a fortnight later. Thus the money was taken off the market only for a few days; but if it was desired to continue the process, it was, of course, always possible to sell them again at the next settlement. When it was desired to make the market easy by putting cash into it, the process was reversed; Consols were bought "for cash" and sold "for the settlement." Now that the amount of Consols has been reduced to a

fraction of what they were before the war, other stocks have to be used. But the discount market and the banks are always large holders of the stocks known as "floaters." These are various stocks, not merely of the British Government, but others of the highest class—principally those which have been issued by the Bank of England itself. The Bank is always prepared to deal in these, taking them as security for loans or selling them through the Government brokers; and it is likely that it is chiefly by dealing in floaters that the Bank can, in fact, if it wishes, control the market. It may, however, be said that the Bank in practice uses its power much more freely in helping the market in times of stress than in creating an artificial scarcity of money.

The importance of the Treasury bills is, however, a development due to the war. The discount market existed for long without them, and still exists, mainly on the financing of international trade by the discounting of commercial bills. It may, in fact, be described as a large reservoir into which are poured the vast proportion of foreign bills drawn upon London.

But before we consider it in greater detail,

a word must be said as to the bills which do not come into this open discount market. The banks discount a great number of bills directly for their customers. These are mostly bills drawn in the ordinary course of trade by comparatively small houses on others whose names do not figure among the large acceptors. A bank is willing to take them, from its knowledge of its customer and from experience of the manner in which his drafts are regularly met by those on whom they are drawn. But the open market prefers to deal with bills which are of unquestioned and well-known standing, whether through their drawers, acceptors or endorsers.

It must also be pointed out that the number of bills which are drawn in payment for the transactions of our internal trade is now very small. Some fifty years ago the "home bills" of the large wholesale warehouses, drawn on their retail customers throughout the country, formed an important element on the discount market. Now they are rarely seen. They used, with few exceptions, to be drawn at three months' date from the first day of the month, so that, with the three days of grace allowed by English law, they used to fall due on the fourth of the month; and the result was that

half a century ago "the fourth of the month" was always a heavy day at the Clearing House, from the number of home bills passing through it. Now the home bill has almost disappeared, and the fourth of the month is no heavier than any other day. The general tendency of the home trade has been towards the accumulation of capital by the retail houses, leading to more rapid payments for cash, in place of the three months' acceptance which was once normal. That a retail house should require to take advantage of the full three months' credit by acceptance would now be regarded almost as a reflection upon its solvency.

As the deposit banks make a rule of never rediscounting bills, none of those which they discount for their own customers ever come upon the discount market at all. Thus it follows that few home bills are ever seen outside the bill-cases of the banks, and even of bills drawn in the foreign trade a certain number are taken directly by the joint-stock banks, and remain with them till maturity. But even after deducting these, the mass of commercial bills which come to London from abroad is so large that they maintain an active market consisting of houses who make

it their practice to deal in them. The discount houses include several large joint-stock companies, as well as a number of private firms. They make it their business to go about the City seeking for bills to discount.

The resources which they use for the purpose of lending on the security of bills—which is, of course, what is meant by discounting—come from three origins. In the first place, they have their own capital, which in the case of the largest houses is very considerable. In the second place, they take deposits from the public on the same lines as the banks, but they give a slightly higher rate of interest. They have to attract these deposits from the public at large, and have not the wide clientele to draw from which the joint-stock banks possess in their own customers. If they are to attract deposits, therefore, it is necessary for them to outbid their large rivals. As a matter of fact they generally advertise a rate of one-quarter to one-half per cent. per annum more than the joint-stock banks.

The third source from which they draw funds for the discount of bills, and the most important one, is the borrowing of money for the purpose from the joint-stock banks themselves. The banks and the discount houses

work, in fact, in a sort of partnership. The discount houses borrow funds from the banks at a cheap rate, and employ them in discounting bills. In this capacity they act as brokers in the strict sense, and the term "bill brokers," by which they are generally known, is strictly applicable. The banks entrust them with funds which they proceed to invest in bills, taking the profit which comes from the fact that they are able to get a better rate for the bills than they pay to the banker. The ordinary term for which these advances are made is one week. In addition the bill brokers make a practice of going round towards the end of the business day and asking if the bankers have any surplus money over after making up their balances for the day. If so, they are often ready to take it till the next day at a somewhat lower rate. This is known as "night" money.

The brokers have in reserve a further source of funds in the fact that the banks are from time to time ready to re-discount the brokers' bills, and put them in their own bill-case. It is a great convenience to the banks to be able to a great extent to choose their own time for filling their bill-cases, as they are apt to have large amounts of bills running off together to

meet periods when cash is particularly needed, for instance at the end of the year. Early in January the banks are usually discounting brokers' bills very readily, as those which they have been holding will have been bought so as to mature within a day or two of December 31 to meet the calls of that very heavy day. The brokers have been fulfilling a function which is very useful to the banks, in holding over bills till the bankers are in want of them. The discount market serves thus as a great reservoir in which bills can be stored up in time of flood, to be released when the banks are ready to find a permanent home for them.

The bill brokers are valuable to the banks also because they guarantee the bills which they discount with the banks. They are not endorsers technically, but they have a standing agreement with the banks that they will be responsible for the bills which they bring in. If one of their bills is not paid when due, the bank can call upon the broker who has discounted it to take it up. The brokers may thus be regarded as specialists in credit acting on behalf of the banks. Of course the banker does not rely upon the broker's judgment entirely, and exercises his own judgment on all

the bills which are brought him, and occasionally will throw out of a parcel brought him by a broker acceptances which he does not like the look of. There is a working alliance between the brokers and the banks for their common advantage. The brokers will consult the banks, for instance, as to the amount of acceptances afloat in the name of one particular house—"Do you think there is too much of So-and-so's paper on the market?"—and the like. Thus a careful and expert watch is kept up which forms a most valuable safeguard against any undue speculation in the acceptance of bills.

The main source of profit to the bill-broker is the difference between the rate at which he can borrow from the banks for a week and that in which he can employ his money in discounting bills. The margin is not a wide one, and calls for a high degree of skill and foresight. On the one hand it is evident that the bill broker can never get, at least for the fine bills with not more than three months to run which form the bulk of his business, anything higher than bank rate; for bank rate means the rate at which the bank announces its willingness to discount such bills itself. And if the bank rate of discount offers an

upper limit to the market rate, the rate allowed by the banks for deposits offers a lower limit. The banks will not lend to the brokers at short date at a less rate than they are paying to their customers for the money placed with them at short date. In fact they are not prepared to lend at the same rate; they always charge a margin for profit. The margin between the rate of interest allowed on deposits and the market rate of discount affords, to some extent, a measure of the profits which the banks are likely to be making over a given period.

It will be noticed that the ordinary term on which the banks receive their London deposits is at seven days' notice, and is the only one which they publicly advertise in common. It is of small moment that they are prepared to take deposits "at call" at a somewhat lower rate, and in some cases advertise their willingness to do so; here, of course, there is no competition. That comes in only where they are prepared to give higher rates to attract money, and this they are not precluded by the agreement from doing provided they require a longer notice for its withdrawal.

The reason for the choice of this special length of notice is that it is the same period,

seven days, which is commonly chosen for the loan of money to the bill brokers; it is necessary for the banks to have a good reserve of deposits fixed for the same period at which they are lending large amounts. And thus it is that the rate of money on deposits at seven days' notice fixes the rate at which money is lent in the market. Before the war, as we have seen, the deposit rate was always fixed at $1\frac{1}{2}\%$ below bank rate; but the difference has now been fixed at 2%.

A consequence of this widening of the margin is that the Governor of the Bank of England finds it more difficult to "make his rate effective"; there are times when, with his eyes on the foreign exchanges, the Governor may wish to see a higher rate for money in London, while, owing to some temporary circumstances, there is a rush to lend money, and rates are depressed. If the banks, owing to competition, are in a position to lend money at more than $1\frac{1}{2}\%$ below the bank rate, it is evident that the Governor can do little to control rates. Under the old system, when the total margin between deposit rates and the rate for money could not show a difference of as much as $1\frac{1}{2}\%$, and practically always showed less,

it was always possible to stiffen the market by a gentle use of the "hidden hand." In order to meet the views of the Bank of England, and assist it in keeping command of the market, it has now become the practice that, when the banks meet for the purpose of fixing their rate of interest, they also fix the minimum at which they will lend to the bill brokers for the week. This rate is fixed, roughly speaking, at about what the rate would have been under the old system—if, that is, the deposit rate had been at $1\frac{1}{2}\%$ instead of 2% below bank rate; but there is no rigid margin, and the rate agreed upon depends rather upon the needs of the situation, with regard mainly to effective support of the policy of the Bank of England.

It is worth pointing out that it is only in respect of the rate on London deposits at seven days' notice that there is anything of the nature of an agreement between the banks in restriction of competition; and that this agreement is imposed upon the joint-stock banks by the policy of the Bank of England. This policy the banks regard it as their duty to support, though they have no voice whatever in shaping it, and indeed have no more knowledge of the steps which the Governor proposes from time to time to take than "the

man in the street." Any of the accusations which from time to time are heard, to the effect that "the banks" have formed a "money trust," can be based only upon this statement, upon the loyalty, in fact, with which the banks support the national system of banking, as laid down by law. In all other respects competition between the banks is unrestricted, and is carried on with the greatest keenness.

The way in which the bill market works is then as follows. The Overseas banks, including the foreign banks, and the Merchant Bankers are continually receiving from abroad supplies of bills which are sent to London for acceptance and ultimate payment. The bill brokers are in constant touch with all the sources from which bills are likely to be on offer, and, especially when the market is easy, will go round asking to be allowed to offer. Most of these bills are due within three months. These are the bills which form the market, as the Bank of England will not discount bills with more than ninety days to run. In some trades, however, it is not unusual to draw bills at longer "usance" up to six months. The bill broker is, as a rule, willing to take a certain amount of these and

to sit upon them till they come within the three months' limit. On these he naturally gets a considerably higher rate; but it is not wise for him to invest in this way more than the capital he has actually invested in the business, and such deposits as he may have from the public fixed for some considerable time ahead.

But for the bulk of his business he depends upon the money lent him by the banks. Every morning the bill brokers call upon the managers of the large banks. The manager who has the responsibility for the "till" will, as we said in Chapter V, have started by estimating his needs for the day. When these are ready he is prepared to receive the bill broker, and tell him how much he is prepared to lend him for the next week.

A certain amount lent to the broker a week ago will be running off to-day. If he is prepared to renew this, well and good. But he may have found that in order to provide a sufficient balance at the Bank he cannot afford to renew, and he will therefore "call" the whole or a part of what is falling due. The bill broker will then find his power of discounting bills reduced by so much; and if the banks generally are short of money and are all calling at once, the market will be tight,

and the broker will charge those who are offering bills for discount a higher rate. If the tightness is more than quite temporary, the rate for bills will run up to close to the figure at which the Bank of England itself is prepared to discount, and the market will look for a rise in the bank rate. The pinch for money may be such that the broker finds himself unable, from the cash at his disposal, to repay the money called by the banks. If, as is likely to be the case, the banks are not in a position to discount the broker's bills, he has no resource but to go to the Bank of England, and either borrow money from them, or discount bills with them. The former alternative is that which he will probably adopt, as paying the central institution a higher rate for money over a short period would be cheaper for him than discounting his bills, which may have a considerable time to run. He will therefore borrow from the Bank on the security of bills or "floaters." But the Bank makes a practice of not lending for a less period than seven days, or at a less rate than "one-half above bank rate." This measures the loss which the bill broker has to face. It is one of the risks of his profession. When the bill brokers are thus driven to the

Bank of England for the temporary loans which the joint-stock banks are unable to give them, in the slang of the City "the market is in the Bank."

It will be readily seen how greatly beneficial to the banks is the existence of this great reservoir of bills. While passing on the larger share of profit to the brokers, they retain for themselves a small but assured margin, and are able to adjust to the needs of the moment their daily requirements in the way of cash. The advantages of the system are the more plainly seen if we compare London with New York. In America, as has been pointed out, the accepting of bills for the purposes of international financing of trade has never struck firm root. The New York banker when he seeks to put out his money at short notice had until recently no resource other than the Stock Exchange. The practice of lending on the Stock Exchange is one resource, as we have seen, for English banks; for the American it is, or was, the only resource. The New York banks send down every morning to bid against one another with rates for their loans. The market is a narrow one in comparison with the number of competing banks, and rates vary in consequence

to an extent which makes the British banker almost dizzy; and they vary, moreover, from causes which have little relation to the conditions of pure banking. When the banks are bidding for borrowers, rates depend on the conditions governing speculation in stocks at the moment. The result is that the American banks are coming more and more to employ their short money in the London bill market, for want of one of their own. The comparative rates of discount in London and New York affect the exchange primarily by this means. At times the American banks—the banks in the Middle West as well as in New York—have held very large sums on the London market; how large it is not possible to say. The withdrawal of them when, on the lowering of the English bank rate, the use of them in London became less profitable, has been a factor of unknown magnitude, which has introduced a good deal of uncertainty into the control of the foreign exchanges by the Bank of England.

The function of the bill market, from the banker's point of view, may be summed up as that of a shock-absorber, which, through the instrumentality of the bill brokers, spreads out evenly the strains which result from the

irregularity of the needs of international trade, an irregularity which inevitably follows from the waxing and waning of the natural elements, seed-time and harvest, storm and calm, as well as from political factors such as strikes or wars or tariff changes. The discount houses take from the banks the more speculative part of these changes and chances, and in return are enabled to win, by the exercise of shrewdness and foresight, a larger part of the profit.

CHAPTER IX

BANK ORGANISATION

THE foundation of a joint-stock bank is, of course, to be found in the body of proprietors, the shareholders who have subscribed the capital, and who receive the profits, in the form of dividends or bonus on their holdings.

In the case of the large English joint-stock banks the ownership is very widely spread among a large body of small holders. The following figures for the "Big Five," published in 1925 by Mr. Walter Runciman, are instructive:

	Paid-up Capital.	Number of Holdings.	Amount of Average Holding. Nominal.	Amount of Average Holding. In Market Value.
Barclays . .	£15,592,372	51,011	£306	£790
Lloyds . . .	14,372,956	55,668	258	774
Midland . .	11,976,890	57,250	209	750
National Provincial . .	9,479,416	41,603	225	684
Westminster .	9,051,718	69,882	130	592 [1] 192 [2]

[1] £20 shares, £5 paid. [2] £1 shares, fully paid.

It will, of course, be readily understood that the above figures represent the number not of shareholders but of shareholdings; in other words, one shareholder will often hold shares of different classes in the same bank, thus appearing twice; and also there will be numerous cases in which the same person will hold shares in different banks. But the fact remains that the British joint-stock banks are essentially owned by quite small investors. In this they differ from the Accepting Houses, which are owned almost entirely by private capitalists—generally by those who manage them, with the support of a certain amount of what may be described as "family" money. With the exception of Hambros Bank already mentioned, they have no shares which are dealt with on the Stock Exchange, or issued to the public. The joint-stock banks differ too, it is believed, from the American banks as a whole. The most important of these are often in the hands of small groups of capitalists, and the bank share is a much less popular investment with the public than it is in Great Britain.

The shareholders delegate their powers of conducting the business of the bank to the Board of Directors. The Directors are neces-

sarily, by the constitution of the bank, shareholders to a certain minimum extent; but as a rule this minimum is not much exceeded, and it is not held desirable that a Director should hold in shares so large a proportion of his fortune as would render the amount of dividend paid by the bank a matter of serious import to his private income. As a Director he is paid fees for the work he does; and it is better that his position as a paid servant of the proprietors should outweigh his private interest in the sharing out of profits. He is a trustee not only for the shareholders, but for the depositors, and indeed for the public at large, whose interests might be largely affected by any laxness in the conduct of his trust. The confidence in British banking which has been acquired by long experience is mainly due to the sense that Directors have conducted the business of their banks with constant attention to public interests in the first place, and have not hesitated to reduce the dividends to their shareholders whenever they considered such action called for in the interest of their depositors.

The delegation of powers to the Directors is, in fact, very complete—more so than in the case of the ordinary trading company.

The only direct control is exercised by the shareholders at the annual general meeting. There they have not as a rule any means of voting upon the dividend, which is declared by the Directors in their report. They frequently take advantage of the occasion to complain that the Directors have not given them a sufficiently large dividend, but they have no means of increasing it unless they are prepared to reject the report of the Board, and so turn the Directors out of office. They also have the power of voting for or against the re-election of the Directors who are retiring by rotation; and they can, of course, criticise freely the policy of the Board, even if they cannot modify it. But their real power over the conduct of the Board is to be found in the fact that they do elect the auditors to represent them, to examine on their behalf the inner working of the business, and to report to them upon it.

Under some banking systems, notably that of the United States, the body which gives the charter under which alone a bank is permitted to carry on business provides that the details of the business shall be supervised on its behalf by official inspectors. Various provisions are laid down, under which such items

as loans and investments must not exceed a certain proportion of the capital of the bank, and so on; the inspectors maintain a constant watch to see that these proportions are not exceeded, and also criticise freely the conditions under which loans are made. The American banks, or at least the best of them, willingly accept this Federal or State supervision, and regard the Government inspectors with a friendly eye, as experienced and impartial advisers, who can often render valuable assistance. But the number of American banks is so great—there are said to be some 30,000 to 40,000 in the United States—that a complete supervision by an adequate staff seems beyond the bounds of practical attainment; and the fact remains that every year there are many bank failures.

There have been in Great Britain from time to time waves of popular opinion calling for legislation under which some system of Government supervision of banks should be undertaken. The cry has generally been to the effect that "bogus" banks should not be allowed to use in their title the name of "bank" or "banking," which is considered to have a magical attraction for the ill-informed depositor. But a difficulty arises

from the certain fact that some at least of the worst cases of bank failures in recent years have been on the part of institutions which have carried on a business which has been quite genuine banking, and whose title to the use of the name "bank" could not be denied. Their practice has been to start a business by offering interest on deposits materially higher than that quoted by the banks of old standing. We have seen that the rate of interest which a bank can offer is controlled by the rate at which it can invest its funds with due regard to their accessibility in time of need. A bank which offers a higher rate can only meet its expenses by investing at a higher rate than the established banks; and the consequence has been that these "wild-cat" banks have been driven into speculative investments promising high returns. These have in the course of time failed, and thus the assets of the bank have fallen to a point at which it was no longer solvent. The temptation has been for the proprietors of the bank—generally individual speculators—to carry on in the hope of recovery, and to this end to issue balance sheets in which no allowance has been made for the depreciation or disappearance of assets; business has been

maintained to the last, and at some moment of stress the crash has come, and the unfortunate depositors, mostly poor people, have found that they have been robbed of all or much of their savings.

In cases such as these it would not be possible to forbid the use of the name "bank"; a banking business is undoubtedly carried on, and the trouble is due not to a false title, but to internal administration. The only remedy lies in a proper supervision of balance sheets, and a truthful and fearless certification of them by responsible auditors. In all the cases of fraudulent bank failures it will be found that the auditor employed to certify the balance sheet has been either the creature of the responsible manager or a principal in the fraud.

It is not long since such a case of fraudulent failure led the Government to discuss with the banks the means by which the public could be protected. It appeared that only two practical courses were open. The Government might follow the American example, and appoint official inspectors to control the operations of the banks—a reversal of the policy on which British banking had grown up, and one which was not acceptable either to the

Government or the banks. Or on the other hand, a sort of official status might be given to the auditors who were employed to audit the balance sheets. In other words, a sort of panel of recognised bank auditors might be drawn up; and any institution which claimed to use the word "bank" or "banking" in its title might be required to employ as auditor a firm or person on this official panel.

There are obvious objections to the official establishment of such a privileged class, and for the present at least any legislative proposals appear to have been shelved.

The growth of joint-stock trading and the responsibilities laid upon auditors by the various Companies' Acts have led to the growth of a number of firms of accountants of the very highest ability and authority who devote themselves to the work of auditing. Their wide experience gives them the position of impartial advisers; and the control which the auditors of a bank exercise over its policy is very real. Once a year the accounts are thoroughly overhauled and discussed with the management of the bank. No self-respecting bank could possibly face anything less than an absolutely clean certificate from its auditors; they have to lay down the conditions

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under which they are prepared to give it. In short, the names of the auditors are the ultimate guarantee to the public that a bank is being conducted on sound lines.

The actual daily administration of the affairs of the bank is primarily in the hands of the managers, and concentrated in the hands of the General Managers at the Head Office. It is shared by the Directors, but it is probable that the part which they take in the actual administration varies considerably from bank to bank. In some cases considerable power is given to local Directors and District Managers; but the most usual practice is probably that of complete centralisation. The Directors will in any case be immediately answerable for all important appointments on the staff; they will be told off to visit branches and make themselves acquainted with the prospects of the bank in different districts; they will thus have an important voice in such matters as the opening of new branches. They may work much through Committees dealing with special aspects of the business, and may have all large transactions submitted to them daily for sanction. And they will be expected to use their influence, when possible, to bring new business to the bank. The value of a

good Board to the business of a bank is very great.

In America the system is somewhat different. Much more is left to the executive officers, who are styled "President" and "Vice-Presidents" instead of "General Managers" and "Assistant General Managers" as in London. The Board of Directors sits only at intervals, and the post of Chairman of the Board is regarded as honourable retirement for a President who has served his time.

Those who are charged with the control of a bank have no more important task than that of selecting and training a succession of men who will in due time be fitted to succeed to the chief offices in the administration. For these qualifications of the highest type are needed. Technical knowledge of the widest kind is essential, including a practical acquaintance with the principles of law as it affects banking. No less important is shrewdness, the power of insight into human nature, the gift of managing men with tact and sympathy. And most important of all is, of course, character—grit, determination, and unflinching integrity. Technical knowledge can to a large extent be tested by examinations; but the others can be judged only by close and

sympathetic observation during the years of development. Thus the practice of the British bankers has long been to take men young, from seventeen or eighteen to twenty or twenty-one, and to give them, after a period of probation in which unpromising candidates can be severely weeded out, the prospect of a steady career, with big prizes at the end for the select few, and for all a good pension at the age of retirement. The career of each clerk is carefully watched; and at the same time his technical education is provided by the Institute of Bankers. This body, supported by the subscriptions of its members supplemented by contributions from the banks, provides lectures and examinations; the staffs of the banks are encouraged to take the courses and to enter for the examinations. Success in these is rewarded by money prizes, and it is understood that the holding of a certificate materially assists promotion. These certificates are issued in evidence of a pass in either the lower or higher examinations, and there is, of course, keen competition for distinction.

The scale of salaries is not exactly the same in the different banks, but of course there cannot be any great variation. There is very little interchange of staff between banks; each

makes it an object to cultivate a sense of loyalty in its staff, and it may be said that a discharge from service for anything less than gross misconduct is unknown. The business of the banks has, moreover, been expanding for a long time at a rate which has made such a thing as unemployment among bank clerks unknown, except for the rare cases in which a small and weak bank has had to be liquidated; even then the surplusage has been rapidly absorbed. It may be said generally that for a young man of good character service in a bank provides a safe but modest provision for life, if he is of average capacity; if he is endowed with ambition and exceptional ability he may rise to a post in which he enjoys great influence and a higher salary than a Cabinet Minister.

The novice has, of course, to begin at the beginning and go through much routine, some of it of a very trying nature. But the way in which he faces it is a test of his grit, and if he shows promise there are various ways in which he will have an opportunity of proving his worth. Somewhere about the middle of his career the man, if he is worth his salt, will be filling positions of responsibility. When he is ripe for a small managership he is in a

position of considerable independence, and is the master in his own branch.

He will, of course, be carefully watched from Head Office. All the managers of branches—and the big banks have many hundreds of them throughout the country—are controlled by a system of inspection which is the foundation of the centralised administration. At unknown times an inspector will call at the office with a clerk, and take possession of all the books, going through them in detail till he is able to report fully on every advance made by the manager, and on the nature and technical perfection of the security held. The advances have, of course, previously required the sanction of the Head Office, unless they do not overstep the moderate amount which the manager is permitted to grant on his own responsibility. On the way in which he manages his branch depends each man's prospect of rising to the highest offices in the central management of the whole bank.

The existing system of bank organisation is the outgrowth of a long series of amalgamation, leading to an immense development of branch banking. The first thing to notice is

that amalgamation has not resulted in any diminution in the number of branches, but in a very large increase; in other words, it has not reduced, but largely stimulated competition between the banks. It was not the intention, when amalgamation was carried out, to save money to any extent by closing competing branches. That has been done to some extent; but it is obvious, to anyone who will walk through London with open eyes, that in very many cases it has led to the maintenance of branches of the same bank in immediate neighbourhood—in some cases actually facing one another across a street; and that new branches are being opened on every hand. It is increased efficiency of administration, developed by the ever-growing sphere of operations, in short a form of "mass production," that has led to this remarkable growth. It was the Scottish banks which first discovered the secret that banking could be profitably developed by a bold system of extension, bringing branches within the immediate reach of all possible customers. The extent to which Scotland led in this development, and to which her example has been followed, appears from the figures herewith.

	Number of Banking Offices.			Number of Inhabitants per Office.		
	1844	1906	1925	1844	1906	1925
England and Wales . .	976	5547	9100	16307	5885	4262
Scotland . .	368	1180	1563	7120	3790	3162
Ireland . .	180	777	1293	45417	5738	3518

It would not be exact to say that, with 9,100 branches, there are, or were last year, as many as 9,100 managers; for a certain number are "sub-branches" under the same management as a neighbouring independent branch. But the proportion of these is small; and even after deducting them it may be said that of the staffs of the great banks a proportion quite unusual in other large businesses is engaged in sharing the task of management. Though under the general control of the Head Office, every manager has a position of personal responsibility, and has to answer not only for the profits of his branch, but for the superintendence of his own branch staff. In some cases at least it may be said that the managers of branches form not far from 10% of the whole of the employees of the bank. There is thus no sharp line to be drawn, as in

most businesses, between "employers" and "employed."

The practice of making the staff of each individual bank into what is almost a closed corporation, the practice, that is, when once the period of probation is over, of discharging a bank clerk for nothing less than grave misconduct, and discouraging any interchange of clerks between the different banks, has certain obvious effects. Each bank carries on its staff a considerable number of men who can at the best be classed as average, and who will never prove themselves capable of taking positions of responsibility. For these, however, the large branches of the bank can always supply plenty of routine work where no more is required than industry and mechanical accuracy. The smaller branches, on the other hand, where each member of the staff has to take a share in many different kinds of work, form the best school for the training of promising young men who are anxious to use their minds.

The constitution of each of the big banks has also brought about the organisation of the staffs themselves, not into a body of the nature of a common Trades Union for the

defence of their interests, but into "Internal Guilds," one for each large bank. A "Bank Officers' Guild" has indeed been formed, but has not achieved the same representative position; and all negotiations between the staffs and the Boards of the big banks are carried on through the mediation of the internal Guilds. These have, however, a joint council which assures, what follows indeed from the competition of the banks themselves, a close similarity, though not actual identity, in the conditions of employment in the various banks.

Of the organisations which bring the banks themselves together two have been already mentioned—the Institute of Bankers, whose special object is the professional training of the young banker; and the British Bankers' Association, established in 1919 to absorb the old "Country Bankers' Association" and unite all British banks in a common body to discuss matters of common interest. But something must be added about another vital piece of banking machinery, the engine, in fact, through which has been evolved the modern cheque, with all its far-reaching effects on the financial development of the country, namely, the London Bankers' Clearing House.

The origin of the Clearing House, like so

much in the history of banking, is obscure; but it is fairly certain that it arose in an unofficial manner. As the system of private deposit banking grew in London, it was necessary for every bank to send round daily "walk clerks" whose business it was to present at each of the other banks the claims upon them in the form of bills and cheques for collection, and bring home the proceeds. It was evident to these walk clerks that they could economise a great deal of time and shoe-leather if, instead of going to each bank to present their "charge" upon it, they all met by agreement in one place, and made their settlement together; and a practice grew up, without the authority of the banks themselves, of holding such meetings in a room at some convenient tavern. Such meetings were apparently being held in 1770, possibly much earlier. By 1773 the practice was officially recognised, and a room for the purpose was hired in Dove Court, Lombard Street. In 1805 this was vacated, and a ground floor room taken in premises adjacent to Smith, Payne and Smiths Bank in Lombard Street. In 1833 the present Clearing House was built in Post Office Court, Lombard Street, once the site of the General Post Office, and in 1834 thirty-nine private

banks combined to buy the freehold of the premises.

This was the moment when the London joint-stock banks were being formed; but the private banks, jealous of the intruders, refused them admission to the Clearing House which they owned; and it was not till 1854 that the monopoly was relaxed, and six joint-stock banks were admitted. The number of private banks had by this time been reduced to twenty-five. By 1895 this number had further fallen to four, and the shares in the private limited company which had been formed to own the freehold were taken over by all the Clearing Banks, who thus became owners instead of tenants. As a matter of fact, however, the actual management of the Clearing House had been in the hands not of the owning company, but of a Committee of the Clearing Bankers—a purely voluntary association, which appears to have no fixed constitution, but exists solely by custom.

The business of the Committee is twofold: it has to manage the Clearing House, which is largely a matter of routine; and it is the body which fixes the rate of deposit interest in the Metropolitan area, as already explained when we were dealing with the discount

market. It is, moreover, a convenient meeting-place where the London banks can discuss matters of common interest; and before the establishment of the British Bankers' Association there was a tendency to regard it as the mouthpiece of the bankers as a whole. But it has never included representatives of the country bankers as such; and when, at the beginning of the war, it was found necessary to have a Committee officially representing the banks in consultation with the Government, a special Committee, known as the Treasury Committee, was chosen unofficially from leading bankers, not necessarily members of the Clearing House Committee, and including important representatives of country banking. That Committee still continues in existence, and is a co-opted body, based not on any definite constitution, but on the general assent of the banking community.

Into the actual mechanism of the Clearing House it is hardly possible to enter. It remains in its essence what it was at first, a meeting-place for the clerks of the various London banks; it has only three officers of its own, the Principal, Deputy and Assistant Inspectors. The rest of the work is carried on by the staffs of the banks themselves. In

its origin it was designed only for clearing the cheques of the various City offices of the banks; and this, now called the "Town" clearing, remains the most important. In addition to the Head Offices of the banks a certain number of City branches are included; the condition is that these must be within a few minutes' "run" of the Clearing House. In 1858 a separate system of clearing was evolved for cheques on country banks and branches; and in 1907 the Metropolitan Clearing was added. The letter T (Town), C (Country), or M (Metropolitan) appears on every cheque, and this simple expedient greatly facilitates the sorting of the cheques preparatory to clearing. The difference between the three is that the settlement between the banks is made, for the Town Clearing, on the day itself on which the cheque is passed into the clearing; the Metropolitan Clearing is settled on the next day, and the Country Clearing on the second day after.

The process of clearing a cheque is briefly this. When it is received by the bank from a customer for collection, and has been duly recorded for credit of his account, it is passed on to the Clearing Department in the office, where the whole mass is sorted out by the

letters T, M and C to the different clearings. Then the "articles" which include all claims to be collected from other banks in the day, such as bills falling due, are sorted out into "charges" on the banks which have to pay them, and these charges are listed on an adding machine, a typewriter which not only records the amounts, but mechanically adds them up at the end of a column by the mere pulling of a handle. The charges thus listed are handed to the "runners" or clerks whose business it is to convey them to the Clearing House. Here are waiting clerks from all the banks, each at his seat, ready to receive the charges, and list them for transmission to the Head Office of his bank. The lists are compared, and the balance is recorded in the sheets of the Clearing House. At the end of the day these balances are added up and each bank knows what it has to receive from and pay to each of the other banks. The differences are made up, and each bank then is debited or credited with the balance it has to pay or receive in the "Clearing Bankers' Account" at the Bank of England; and these balances are at once settled by draft on the Bank of England, so that the Clearing Bankers' Account is balanced up every evening, since the

inter-bank payments and receipts must always be equal.

The amounts which pass in this way through the Clearing are gigantic. The total amount cleared during 1925 was no less than £40,437,119,000, and as much as £263,255,000 has been cleared in a single day. It is by the certainty and rapidity of this machinery that the cheque has attained its vogue in Great Britain and the United States. It has largely supplanted the use of metallic and paper currency. Indeed it is the growth of the cheque system, combined with the steady output of gold, which have rendered the limitation to the fiduciary issue of notes imposed by the Bank Charter Act of 1844 so long of life.

In significant contrast is the French practice. No clearing system existed till some six years ago, when a "Chambre de Compensation" was established in Paris. The reason for this is that the cheque system is as yet hardly developed in France. Indeed all deposit banking is still in its infancy. Payments are largely made by the acceptance of bills for quite small amounts; and the acceptor makes the bill payable not, as in England, at his banker's but at his own house. The large firms, of

course, have gradually accustomed themselves to the cheque system, and with it has followed the adoption of clearing for bank payments; but the mass of small traders still adhere to the practice of keeping their cash at home, and a large expense and great risk has to be incurred by all the banks in the employment of messengers who go round to private addresses to collect payment of bills, often of quite trifling amount. Even Germany still lags behind, though considerable progress in the use of the cheque was made, under Government pressure, during the war. It is the concentration of payments in the Clearing House which symbolises the extent to which British and American banking have developed the use of the cheque, and made of deposit banking the most powerful auxiliary to the expansion of industry and commerce.

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